# the CATO JOURNAL

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**John B. Egger • Steven J. Eagle • Giulio M. Gallarotti**
**Ben W. Bolch • Tom G. Palmer**



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**EDITOR'S NOTE**

The Fall 1995 and Winter 1996 issues of the *Cato Journal* (numbers 2 and 3 of volume 15) are combined in one issue. This combined issue will be treated as a single issue for *Cato Journal* subscribers. Thus, current annual subscribers will receive one additional issue of the *Cato Journal*.

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# Empowering Workers: The Privatization of Social Security in Chile

*José Piñera*

A specter is haunting the world. It is the specter of bankrupt state-run pension systems. The pay-as-you-go pension system that has reigned supreme through most of this century has a fundamental flaw, one rooted in a false conception of how human beings behave: it destroys, at the individual level, the essential link between effort and reward—in other words, between personal responsibilities and personal rights. Whenever that happens on a massive scale and for a long period of time, the result is disaster.

Two exogenous factors aggravate the results of that flaw: (1) the global demographic trend toward decreasing fertility rates; and, (2) medical advances that are lengthening life. As a result, fewer and fewer workers are supporting more and more retirees. Since the raising of both the retirement age and payroll taxes has an upper limit, sooner or later the system has to reduce the promised benefits, a telltale sign of a bankrupt system.

Whether this reduction of benefits is done through inflation, as in most developing countries, or through legislation, the final result for the retired worker is the same: anguish in old age created, paradoxically, by the inherent insecurity of the "social security" system.

In 1980, the government of Chile decided to take the bull by the horns. A government-run pension system was replaced with a revolutionary innovation: a privately administered, national system of Pension Savings Accounts.

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José Piñera is President of the International Center for Pension Reform and Co-Chairman of the Cato Project on Social Security Privatization. As Minister of Labor and Social Security from 1978 to 1980, he was responsible for the privatization of the Chilean pension system. This paper is based on a presentation made at the Mont Pèlerin Society's regional meeting in Cancun, Mexico, January 17, 1996. The author wishes to thank Edward H. Crane for helpful comments.



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After 15 years of operation, the results speak for themselves. Pensions in the new private system already are 50 to 100 percent higher—depending on whether they are old-age, disability, or survivor pensions—than they were in the pay-as-you-go system. The resources administered by the private pension funds amount to $25 billion, or around 40 percent of GNP as of 1995. By improving the functioning of both the capital and the labor markets, pension privatization has been one of the key reforms that has pushed the growth rate of the economy upwards from the historical 3 percent a year to 6.5 percent on average during the last 12 years. It is also a fact that the Chilean savings rate has increased to 27 percent of GNP and the unemployment rate has decreased to 5.0 percent since the reform was undertaken.

More important, still, pensions have ceased to be a government issue, thus depoliticizing a huge sector of the economy and giving individuals more control over their own lives. The structural flaw has been eliminated and the future of pensions depends on individual behavior and market developments.

The success of the Chilean private pension system has led three other South American countries to follow suit. In recent years, Argentina (1994), Peru (1993), and Colombia (1994) undertook a similar reform. In the four South American countries, around 11 million workers have a personal retirement account.

The Chilean experience can be instructive to countries around the world. Even the United States is beginning to seriously debate privatizing its 60-year-old pension scheme. It should be noted that the U.S. Social Security system is the largest single government program in the world, spending more than $350 billion per year (more than the U.S. defense budget during the Cold War).

As an indication of the power of ideas, even officials from the People's Republic of China have come to Chile to study the private pension system. One of the results is this particularly interesting feud reported recently by *The Economist*:

> There is usually more acrimony than comedy in the long-running row between Britain and China over the future of Hong Kong. Yet a smile may have flickered across the face of Chris Patten, Hong Kong's governor, even as China scuppered his plans to introduce a (pay-as-you-go) pension scheme in the colony. Zhou Nan, Communist China's main representative in Hong Kong, harrumphed that Mr. Patten, a British conservative, was trying to bring "costly Euro-socialist" ideas to Hong Kong [11 February 1995].

It is possible that before entering the new millennium, several other countries, including all those in the Americas, will have privatized


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their pension system. This would mean a massive redistribution of power from the state to individuals, thus enhancing personal freedom, promoting faster economic growth, and alleviating poverty, especially in old age.

## The Chilean PSA System

Under Chile's Pension Savings Account (PSA) system, what determines a worker's pension level is the amount of money he accumulates during his working years. Neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect a government-funded pension. Instead, during his working life, he automatically has 10 percent of his wages deposited by his employer each month in his own, individual PSA. This percentage applies only to the first $22,000 of annual income. Therefore, as wages go up with economic growth, the "mandatory savings" content of the pension system goes down.

A worker may contribute an additional 10 percent of his wages each month, which is also deductible from taxable income, as a form of voluntary savings. Generally a worker will contribute more than 10 percent of his salary if he wants to retire early or obtain a higher pension.

A worker chooses one of the private Pension Fund Administration companies ("Administradoras de Fondos de Pensiones," AFPs) to manage his PSA. These companies can engage in no other activities and are subject to government regulation intended to guarantee a diversified and low-risk portfolio and to prevent theft or fraud. A separate government entity, a highly technical "AFP Superintendency," provides oversight. Of course, there is free entry to the AFP industry.

Each AFP operates the equivalent of a mutual fund that invests in stocks and bonds. Investment decisions are made by the AFP. Government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and the spirit of the reform is that those regulations should be reduced constantly with the passage of time and as the AFP companies gain experience. There is no obligation whatsoever to invest in government or any other type of bonds. Legally, the AFP company and the mutual fund that it administers are two separate entities. Thus, should an AFP go under, the assets of the mutual fund—that is, the workers' investments—are not affected.

Workers are free to change from one AFP company to another. For this reason there is competition among the companies to provide



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a higher return on investment, better customer service, or a lower commission. Each worker is given a PSA passbook and every three months receives a regular statement informing him how much money has been accumulated in his retirement account and how well his investment fund has performed. The account bears the worker's name, is his property, and will be used to pay his old age pension (with a provision for survivors' benefits).

As should be expected, individual preferences about old age differ as much as any other preferences. Some people want to work forever; others cannot wait to cease working and to indulge in their true vocations or hobbies, like writing or fishing. The old, pay-as-you-go system did not permit the satisfaction of such preferences, except through collective pressure to have, for example, an early retirement age for powerful political constituencies. It was a one-size-fits-all scheme that exacted a price in human happiness.

The PSA system, on the other hand, allows for individual preferences to be translated into individual decisions that will produce the desired outcome. In the branch offices of many AFPs, there are user-friendly computer terminals that permit the worker to calculate the expected value of his future pension, based on the money in his account, and the year in which he wishes to retire. Alternatively, the worker can specify the pension amount he hopes to receive and ask the computer how much he must deposit each month if he wants to retire at a given age. Once he gets the answer, he simply asks his employer to withdraw that new percentage from his salary. Of course, he can adjust that figure as time goes on, depending on the actual yield of his pension fund. The bottom line is that a worker can determine his desired pension and retirement age in the same way one can order a tailor-made suit.

As noted above, worker contributions are deductible for income tax purposes. The return on the PSA is tax free. Upon retirement, when funds are withdrawn, taxes are paid according to the income tax bracket at that moment.

The Chilean PSA system includes both private and public sector employees. The only ones excluded are members of the police and armed forces, whose pension systems, as in other countries, are built into their pay and working conditions system. (In my opinion—but not yet theirs—they would also be better off with a PSA). All other employed workers must have a PSA. Self-employed workers may enter the system, if they wish, thus creating an incentive for informal workers to join the formal economy.

A worker who has contributed for at least 20 years but whose pension fund, upon reaching retirement age, is below the legally



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defined "minimum pension" receives that pension from the state once his PSA has been depleted. What should be stressed here is that no one is defined as "poor" a priori. Only a posteriori, after his working life has ended and his PSA has been depleted, does a poor pensioner receive a government subsidy. (Those without 20 years of contributions can apply for a welfare-type pension at a much lower level.)

The PSA system also includes insurance against premature death and disability. Each AFP provides this service to its clients by taking out group life and disability coverage from private life insurance companies. This coverage is paid for by an additional worker contribution of around 2.9 percent of salary, which includes the commission to the AFP.

The mandatory minimum savings level of 10 percent was calculated on the assumption of a 4 percent average net yield during the whole working life, so that the typical worker would have sufficient money in his PSA to fund a pension equal to 70 percent of his final salary.

The so-called legal retirement age is 65 for men and 60 for women. Those retirement ages—the traditional ages in the pay-as-you-go system—were not discussed in the privatization reform because they are not a structural characteristic of the new system. But the meaning of "retirement" in the PSA system is different than in the traditional one. First, workers can continue working after retirement. If they do, they receive the pension their accumulated capital makes possible and they are not required to contribute any longer to a pension plan. Second, workers with sufficient savings in their accounts to fund a "reasonable pension" (50 percent of the average salary of the previous 10 years, as long as it is higher than the "minimum pension") may choose to take early retirement whenever they want.

Thus, the 65-60 threshold is not a rigid fixture of the system. Rather, a worker must continue making a 10 percent contribution to his PSA until he reaches that age, unless he has chosen early retirement—that is, to retire his money, as a monthly pension, which is not the same as retirement from the workforce. In addition, however, a worker must reach those threshold ages to be eligible for the government subsidy that guarantees a minimum pension.

But in no way is there an obligation to cease working, at any age, nor is there an obligation to continue working or saving for pension purposes once you have assured yourself a "reasonable pension" as described above.

Upon retiring, a worker may choose from two general payout options. In one case, a retiree may use the capital in his PSA to purchase an annuity from any private life insurance company. The annuity guarantees a constant monthly income for life, indexed to



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inflation (there are indexed bonds available in the Chilean capital market so that companies can invest accordingly), plus survivors' benefits for the worker's dependents. Alternatively, a retiree may leave his funds in the PSA and make programmed withdrawals, subject to limits based on the life expectancy of the retiree and his dependents. In the latter case, if he dies, the remaining funds in his account form a part of his estate. In both cases, he can withdraw as a lump-sum the capital in excess of that needed to obtain an annuity or programmed withdrawal equal to 70 percent of his last wages.

The PSA system solves the typical problem of pay-as-you-go systems with respect to labor demographics: in an aging population the number of workers per retiree decreases. Under the PSA system, the working population does not pay for the retired population. Thus, in contrast with the pay-as-you-go system, the potential for inter-generational conflict and eventual bankruptcy is avoided. The problem that many countries face—unfunded pension liabilities—does not exist under the PSA system.

In contrast to company-based private pension systems that generally impose costs on workers who leave before a given number of years and that sometimes result in bankruptcy of the workers' pension funds—thus depriving workers of both their jobs and their pension rights—the PSA system is completely independent of the company employing the worker. Since the PSA is tied to the worker, not the company, the account is fully portable. Given that the pension funds must be invested in tradeable securities, the PSA has a daily value and therefore is easy to transfer from one AFP to another. The problem of "job lock" is entirely avoided. By not impinging on labor mobility, both inside a country and internationally, the PSA system helps create labor market flexibility and neither subsidizes nor penalizes immigrants.

A PSA system is also much more efficient in promoting a flexible labor market. In fact, people are increasingly deciding to work only a few hours a day or to interrupt their working lives—especially women and young people. In pay-as-you-go systems, those flexible working styles create the problem of filling the gaps in contributions. Not so in a PSA scheme where stop-and-go contributions are no problem whatsoever.

## The Transition

One challenge is to define the permanent PSA system. Another, in countries that already have a pay-as-you-go system, is to manage the transition to a PSA system. The transition has to take into account



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the particular characteristics of each country, of course, especially constraints posed by the budget situation.

In Chile we set three basic rules for the transition:

1. The government guaranteed those already receiving a pension that their pensions would be unaffected by the reform. This rule was important because the social security authority would obviously cease to receive the contributions from the workers who moved to the new system. Therefore the authority would be unable to continue paying pensioners with its own resources. Moreover, it would be unfair to the elderly to change their benefits or expectations at this point in their lives.
2. Every worker already contributing to the pay-as-you-go system was given the choice of staying in that system or moving to the new PSA system. Those who left the old system were given a "recognition bond" that was deposited in their new PSAs. (The bond was indexed and carried a 4 percent real interest rate.) The government pays the bond only when the worker reaches the legal retirement age. The bonds are traded in secondary markets, so as to allow them to be used for early retirement. This bond reflected the rights the worker had already acquired in the pay-as-you-go system. Thus, a worker who had made pension contributions for years did not have to start at zero when he entered the new system.
3. All new entrants to the labor force were required to enter the PSA system. The door was closed to the pay-as-you-go system because it was unsustainable. This requirement assured the complete end of the old system once the last worker who remained in it reaches retirement age (from then on, and for a limited period of time, the government has only to pay pensions to retirees of the old system). This rule is important because the most effective way to reduce the size of the government in our lives is to end programs completely, not simply scale them back so that a new government might revive them at a later date.

After several months of national debate on the proposed reforms, and a communication and education effort to explain the reform to the people,[1] the pension reform law was approved on November 4, 1980.

To give equal access to creating AFPs to all those who might be interested, the law established a six-month period during which no AFP could begin operations (not even advertising). Thus, the AFP

[1]See Piñera (1991) and (1995).



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industry is unique in that it had a clear day of conception (November 4, 1980) and a clear date of birth (May 1, 1981).

In Chile, as in most countries (but not the United States), May 1 is Labor Day. The choice of that date was not a coincidence. Symbols are important, and that date of birth allows workers to celebrate May 1 not as a day of class struggle but as the day when they were freed to choose their own pension system and thus freed from "the chains" of the state-run social security system.

Together with the creation of the new AFP system, all gross wages were redefined to include most of the employer's contribution to the old pension system. (The rest of the employer's contribution was turned into a transitory tax on the use of labor to help the financing of the transition; once that tax was completely phased out, as established in the pension reform law, the cost to the employer of hiring workers decreased.) The worker's contribution was deducted from the increased gross wage. Because the total contribution was lower in the new system than in the old, net salaries for those who moved to the new system increased by around 5 percent.

In that way, we ended the illusion that both the employer and the worker contribute to social security, a device that allows political manipulation of those rates. From an economic standpoint, workers bear nearly the full burden of the payroll tax because the aggregate supply of labor is highly inelastic. Also, all the contributions are ultimately paid from the worker's marginal productivity, and employers must take into account all labor costs—whether termed salary or social security contributions—in making their hiring and pay decisions. By renaming the employer's contribution, the system makes it evident that all contributions are made by the worker. In this scenario, of course, the final wage level is determined by the interplay of market forces.

The financing of the transition is a complex technical issue and each country must address this problem according to its own circumstances. The implicit pay-as-you-go debt of the Chilean system in 1980 has been estimated at around 80 percent of GDP.[2] (The value of that debt had been reduced by a reform of the old system in 1978, especially by the rationalization of indexing, the elimination of special regimes, and the raising of the retirement age.)

A recent World Bank study (1994: 268) stated that "Chile shows that a country with a reasonably competitive banking system, a well-functioning debt market, and a fair degree of macroeconomic stability

[2]See World Bank (1994).



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can finance large transition deficits without large interest rate repercussions."

Chile used five methods to finance the short-run fiscal costs of changing to a PSA system:

1. In the state's balance sheet (in which each government should show its assets and liabilities), state pension obligations were offset to some extent by the value of state-owned enterprises and other types of assets. Therefore, privatization was not only one way to finance the transition but had several additional benefits such as increasing efficiency, spreading ownership, and depoliticizing the economy.
2. Since the contribution needed in a capitalization system to finance adequate pension levels is generally lower than the current payroll taxes, a fraction of the difference between them can be used as a temporary transition tax without reducing net wages or increasing the cost of labor to the employer.
3. Using debt, the transition cost can be shared by future generations. In Chile, roughly 40 percent of the cost has been financed by issuing government bonds at market rates of interest. These bonds have been bought mainly by the AFPs as part of their investment portfolios and that "bridge debt" should be completely redeemed when the pensioners of the old system are no longer with us (a source of sadness to their families and friends, but, undoubtedly, a source of relief to future ministers of finance).
4. The need to finance the transition was a powerful incentive to reduce wasteful government spending. For years, the budget director has been able to use this argument to kill unjustified new spending or to reduce wasteful government programs.
5. The increased economic growth that the PSA system promoted substantially increased tax revenues, especially those from the value-added tax. Only 15 years after the pension reform, Chile is running fiscal budget surpluses.

## The Results

The PSAs have already accumulated an investment fund of $25 billion, an unusually large pool of internally generated capital for a developing country of 14 million people and a GDP of $60 billion.

This long-term investment capital has not only helped fund economic growth but has spurred the development of efficient financial markets and institutions. The decision to create the PSA system first, and then privatize the large state-owned companies second, resulted



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in a "virtuous sequence." It gave workers the possibility of benefiting handsomely from the enormous increase in productivity of the privatized companies by allowing workers, through higher stock prices that increased the yield of their PSAs, to capture a large share of the wealth created by the privatization process.

There are around 15 AFP companies and they are a diverse group. Some belong to insurance or banking conglomerates. Others are worker-owned or tied to labor unions or specific industry or trade associations. Some include the participation of international financial companies, such as AIG, Aetna, and Banco de Santander. Several of the larger AFP companies are themselves publicly traded on the Chilean stock exchange, and one of them recently issued American depository receipts on Wall Street (helped by the recent "A−" credit rating of Chilean sovereign bonds).

One of the key results of the new system has been to increase the productivity of capital and thus the rate of economic growth in the Chilean economy. The PSA system has made the capital market more efficient and influenced its growth over the past 15 years. The vast resources administered by the AFPs have encouraged the creation of new kinds of financial instruments while enhancing others already in existence but not fully developed. Another of Chile's pension reform contributions to the sound operation and transparency of the capital market has been the creation of a domestic risk-rating industry and the improvement of corporate governance. (The AFPs appoint outside directors in the companies in which they own shares, thus shattering complacency at board meetings.)

Since the system began to operate on May 1, 1981, the average real return on investment has been 13 percent per year (more than three times higher than the anticipated yield of 4 percent). Of course, the annual yield has shown the oscillations that are intrinsic to the free market—ranging from minus 3 percent to plus 30 percent in real terms—but the important yield is the average one over the long term.

Pensions under the new system have been significantly higher than under the old, state-administered system, which required a total payroll tax of around 25 percent. According to a recent study by Sergio Baeza (1995), the average AFP retiree is receiving a pension equal to 78 percent of his mean annual income over the previous 10 years of his working life. As mentioned, upon retirement workers may withdraw in a lump sum their "excess savings" (above the 70 percent of salary threshold). If that money were included in calculating the value of the pension, the total value would come close to 84 percent of working income. Recipients of disability pensions also receive, on average, 70 percent of their working income.



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The new pension system, therefore, has made a significant contribution to the reduction of poverty by increasing the size and certainty of old-age, survivors, and disability pensions, and by the indirect but very powerful effect of promoting economic growth and employment.

The new system also has eliminated the unfairness of the old system. According to conventional wisdom, pay-as-you-go pension schemes redistribute income from the rich to the poor. However, recent studies have shown that once certain income-specific characteristics of workers and of the operation of the political system are taken into account, public schemes generally redistribute income to the rich—and especially to the most powerful groups of workers.[3]

## Conclusion

It is not surprising that the PSA system in Chile has proven so popular and has helped promote social and economic stability. Workers appreciate the fairness of the system and they have obtained through their pension accounts a direct and visible stake in the economy. Since the private pension funds own a sizable fraction of the stocks of the biggest companies of Chile, workers are actually investors in the country's fortunes.

When the PSA was inaugurated in Chile in 1981, workers were given the choice of entering the new system or remaining in the old one. Half a million Chilean workers (one fourth of the eligible workforce) chose the new system by joining in the first month of operation alone—far more than the 50,000 that had been expected. Today, more than 90 percent of Chilean workers who had been under the old system are in the new system. By 1995, 5 million Chileans had PSA accounts, although not all belonged to active, full-time workers, and therefore not all contribute in any given month.

The bottom line is that when given a choice, workers vote with their money overwhelmingly for the free market—even when it comes to such "sacred cows" as social security.

As the state pension system disappears, politicians will no longer decide whether pension checks need to be increased and in what amount or for which groups. Thus, pensions are no longer a key source of political conflict and election-time demagoguery as they once were. A person's retirement income will depend on his own work and on the success of the economy, not on the government or on the pressures brought by special interest groups.

[3]See Baeza (1995) and World Bank (1994).



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For Chileans, pension savings accounts now represent real and visible property rights—they are the primary sources of security for retirement. After 15 years of operation of the new system, in fact, the typical Chilean worker's main asset is not his used car or even his small house (probably still mortgaged), but the capital in his PSA.

Finally, the private pension system has had a very important political and cultural consequence. The overwhelming majority of Chilean workers who chose to move into the new system moved into it faster than Germans going from East to West after the fall of the Berlin Wall. Those workers freely decided to abandon the state system even though some of the national trade-union leaders and the old political class advised against it. Workers care deeply about matters close to their lives, such as pensions, education, and health, and make their decisions thinking about their families and not according to political fashions.

Indeed, the new pension system gives Chileans a personal stake in the economy. A typical Chilean worker is not indifferent to the behavior of the stock market or interest rates. Intuitively he knows that a bad minister of finance can reduce the value of his pension rights. When workers feel that they own a part of the country, not through party bosses or a Politburo, they are much more attached to the free market and a free society.

This is a brief story of a dream that has come true. The ultimate lesson is that the only revolutions that are successful are those that trust the individual, and the wonders that individuals can do when they are free.

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# Governments and Money

*Jerry L. Jordan*

> We do not pretend, that a National Bank can establish and maintain a sound and uniform state of currency in the country, in spite of the National Government; but we do say that it has established and maintained such a currency, and can do so again, by the aid of that Government; and we further say, that no duty is more imperative on that Government, than the duty it owes the people, of furnishing them a sound and uniform currency.
>
> —Abraham Lincoln

Abraham Lincoln connected sound banking with political liberty, affirming that government has both the ability and the obligation to provide a stable currency. His belief in the importance of a sound currency has been shared by most thinkers for the past 250 years.

Lincoln's view that government would actually provide a stable currency, however, has enjoyed less acceptance. Skepticism about the government's role with regard to money has been the dominant view since the founding of the republic. These doubts are well summarized by prominent 20th-century economist Ludwig von Mises (1949: 422):

> Whatever a government does in the pursuit of aims to influence the height of purchasing power depends necessarily upon the ruler's personal value judgments. It always furthers the interests of some people at the expense of other groups. It never serves what is called the commonweal or the public welfare.

Constitutional forms of government usually specified a stable currency, but as James Buchanan (1994: 4) recently observed, such provisions have been inadequate:

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Jerry L. Jordan is President and Chief Executive Officer of the Federal Reserve Bank of Cleveland. This paper is based on a presentation made at the Mont Pèlerin Society's regional meeting in Cancun, Mexico, January 16, 1996. The author thanks Charles T. Carlstrom and Mark S. Sniderman for helpful comments.



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This framework role for government also was considered to include the establishment of a monetary standard, and in such fashion as to insure predictability in the value of the designated monetary unit. (It is in the monetary responsibility that almost all constitutions have failed, even those that were allegedly motivated originally by classical liberal precepts. Governments, throughout history, have almost always moved beyond constitutionally authorized limits of their monetary authority.)

## Debates about Money

History is unfortunately replete with examples of governments trying to print money in order to finance their expenditures. Nobel Prize winning economist Friedrich von Hayek (1976: 29) put it this way: "History is largely a history of inflation, and usually of inflations engineered by governments and for the gain of governments." In recent times, the hyperinflations of Germany in the 1920s and of Bolivia, Argentina, and Brazil in the 1980s are all examples of governments debasing their currencies and engaging in what Mises (1949: 782) called "a fraudulent attempt to cheat the public."

Until the second half of the current century, there was little intellectual disagreement that a stable currency was best. The debate centered on how to provide it. The notion that some inflation might be desirable (or at least should be tolerated) entered public policy debates for a relatively short time in the post–World War II period. After enduring painful inflation experiences in the 1960s and 1970s, though, the question of whether to eliminate inflation is no longer widely debated.

In the closing years of this millennium, the problem of how to provide a stable value of money has regained prominence. Alternative approaches to stabilizing currencies are being pursued around the world. Public policy debates have returned to this issue because people are rethinking the role of government in their societies. The likely monetary institutions of the 21st century will reflect the dynamic economic and political processes currently at work. It remains to be seen whether nations achieve and maintain stable currencies because of government, as Abraham Lincoln believed, or in spite of government, as thinkers as diverse as James Madison, Mises, and Hayek contended.

Sentiment that government powers should be constrained by constitutional design is certainly not unique to the monetary arena. For example, Madison set forth principles of government that underscore his views on money. In his elaboration of the "rule of law," he comments, "To trace the mischievous effects of a mutable government would fill a volume" (*The Federalist*, No. 45). His doubts about elected



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representatives' ability to provide a stable currency are reflected clearly in his adherence to a specie standard. Madison's defense of an exclusive role of Congress boils down to a distrust of populist sentiments: "A rage for paper money, for an abolition of debts, for an equal division of property, or for any other improper or wicked project, will be less apt to pervade the whole body of the Union than a particular member of it" (*The Federalist,* No. 10).

The history of money over the past two centuries shows the world groping for different institutional structures that limit governments' temptations to debase money in order to satisfy some shortsighted political objectives. The approaches used in the past have been functions of the nature of money prevailing at the time and of societies' views about the proper role of government. The approaches used in the coming century will surely be different from those of the past 200 years if either of these two factors changes materially. In particular, while government will surely have some responsibility in providing a stable currency, government's exact role should not be taken for granted.

## What Is Money?

Adam Smith ([1776] 1976: 309) defined the role of money as a medium of exchange, describing it as "the great wheel of circulation." However, money functions in at least two other ways: as a store of value and as a standard of value (unit of account). When we hold money, we trust that it will largely maintain its worth. If the value of currency is allowed to erode under conditions of inflation, the ability of money to serve as a store of value is seriously hampered. As a unit of account, money serves as a measuring stick, telling us how many units of something exchange for a unit of money.[1]

An often-overlooked consideration is that while money is an integral part of society because of its service of these three roles, it is not desired for its own sake. Smith ([1776] 1976: 458–60) pointed out, "No complaint, however, is more common than that of a scarcity of money. Money, like wine, must always be scarce with those who have neither wherewithal to buy it, nor credit to borrow it. . . . It is not for

[1]An appreciation of this role was evident in the thinking of Thomas Jefferson (1819), who confided to a friend: "There is, indeed, one evil which awakens me at times, because it jostles me at every turn. It is that we have now no measure of value. I am asked eighteen dollars for a yard of broadcloth, which, when we had dollars, I used to get for eighteen shillings; from this I can only understand that a dollar is now worth but two inches of broadcloth, but broadcloth is no standard of value. I do not know, therefore, whereabouts I stand in the scale of property, nor what to ask, or what to give for it."



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its own sake that men desire money, but for the sake of what they can purchase with it."

This confusion between more money and more purchasing power has contributed in large part to the pervading lack of trust in government provision of money. As Mises suggests, governments are often tempted to answer the cry for more purchasing power by simply creating more money. But in so doing, the opposite effect is achieved—the purchasing power of money is actually reduced. The result, as Alchian and Allen (1977: 484) explain, is inflation: "a rise in the number of dollars required to purchase a given standard of living."

If inflation makes individuals uncertain about what to ask or what to give for goods or services, then the quality of money deteriorates, reducing its effectiveness as a medium of exchange. Money is no longer either an efficient store of value or an efficient unit of account, because this "ruler" with which we make our measurements is continually changing.

Three points are clear. First, inflation is highly undesirable. Second, governments have incentives to abuse their power of mintage which, coupled with historical experience, has slowly created a consensus among citizens that they cannot trust their governments with unfettered control over money. Third, the mechanisms people have contrived to protect themselves from the seemingly arbitrary debasement of currency have varied over time.

## The Gold Standard

For most of recorded history, governments have taken some role in providing money to the economy. In early times, that role was limited to "authentication"— verifying that coins contained the indicated metals. Even in historical monarchies, however, the authorities would occasionally lie to their people about money. People's dual reliance on and distrust of government with regard to the value of money is an age-old phenomenon.

The view that, despite all contrary assurances, governments will eventually abuse their powers as counterfeiters led countries to develop institutions aimed at limiting a government's ability to print additional money. One such method was the gold and silver standards followed (on and off) by most countries from 1821 to 1973.

Specie-backed currency took money out of immediate government control. For example, if the dollar were defined as equal to 1/20 of an ounce of gold, then the number of dollars that the United States could issue would be constrained by its holdings of gold reserves. Moreover, if Britain then defined its currency as equal to 5/20 of



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an ounce of gold—as it did before World War I—the dollar/pound exchange rate would be fixed at $5 per pound. If either government issued more currency than proscribed by its gold standard—say, to finance a budget deficit—it would lose gold reserves to the country with the more stable currency. In this way, gold strengthened a government's covenant with its public not to erode the purchasing power of its money.

The unfortunate problem with a specie standard was that the value of money was only as stable as the value of the specie backing it. This led Benjamin Franklin (1729) to note that because "silver itself is of no certain permanent Value, being worth more or less according to its Scarcity or Plenty, therefore it seems requisite to fix upon something else, more proper to be made a *Measure of Values*."

Although a specie standard could clearly result in undesirable swings in the purchasing power of money, the costs of having a fiat currency were thought to be even higher. In a letter to a friend, Madison (1820) stated, "It cannot be doubted that a paper currency, rigidly limited in its quantity to purposes absolutely necessary, may be equal and even superior in value to specie. But experience does not favor reliance on such experiments. Whenever the paper has not been convertible into specie, and its quantity has depended on the policy of the Government, a depreciation has been produced by an undue increase, or an apprehension of it."

Later, commenting on a "Report on a State's Bank," Madison (1831) wrote, "But I am not yet weaned from the opinion long entertained, that the only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie." Repeating his view that a stable paper currency is theoretically possible, doubts remained: "What is to ensure the inflexible adherence of the Legislative Ensurer to their own principles and purposes?" Madison left no doubt about what is essential—a money that has stable value. His doubts about the people's elected representatives providing a stable currency are reflected clearly in his adherence to a specie standard—especially given his recognition that paper money supplied by an honest government is superior to a specie standard.

The quantity theorists of the late 19th century, John Stuart Mill and Alfred Marshall, also believed that although a gold standard provided undesirable swings in currency value, it was the only way for governments to provide a stable paper currency. Mill (1907) observed,

> After experience had shown that pieces of paper, of no intrinsic value, by merely bearing upon them the written profession of being equivalent to a certain number of francs, dollars, or pounds . . . governments began to think that it would be a happy device if they

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> could appropriate to themselves this benefit. . . . The only question is, what determines the value of such a currency. . . . We have seen, however, that even in the case of metallic currency, the immediate agency in determining its value is its quantity. . . . The value, therefore, of such a currency is entirely arbitrary.

Citing 19th-century economist William Jevons, Mill asserts, "The relation of quantity to uses is the only thing which can give value to *fiat* money." That being the case, Mill thought that convertibility (to metal) was the only thing to prevent temptation to "depreciate the currency without limit."

For the first 195 years following the Declaration of Independence, most government paper currencies were linked to specie. The U.S. dollar was defined in terms of a weight of gold (or occasionally silver). However, this did not completely restrain governments from manipulating the value of their currencies. First, in order to generate revenue, countries would frequently abandon the gold standard during times of war. Second, even without officially abandoning gold, countries can and did periodically redefine the value of their currencies in terms of gold. Instead of allowing gold or foreign reserves to consistently drain from their coffers, they would "be forced" to devalue their currency.

At first glance, it would appear that a gold standard provided no real discipline if countries could devalue their currencies at will. The discipline came from the fact that countries actually could not do so without suffering a cost. If it was threatened that a country would devalue its currency, massive speculative attacks would ensue as investors attempted to shed themselves of that currency. The devaluing country would eventually lose massive amounts of foreign reserves (gold and foreign currencies). For instance, Britain lost nearly 28 million ounces of its gold reserves defending its currency in 1966–67. On a single day (November 17, 1967), Britain lost reserves valued at more than $1 billion.

The common wisdom is that the frequency and destabilizing effects of such attacks caused the Bretton Woods system, and thus the last vestige of a gold standard, to be abandoned in 1973. While this is correct on a superficial level, the underlying cause was that despite the threat of speculative attacks, governments around the world were unwilling to do what was necessary to maintain a stable currency—namely, to limit the supply of fiat money.

On the subject of deliberate, governmentally engineered devaluations of currency, Mises was blunt in his condemnation. His criticism of the stated as well as the unstated objectives of a devaluation policy are as relevant today as when he wrote *Human Action* almost 50 years



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ago (1949: 790): "It is impossible to take seriously the arguments advanced in favor of devaluation."

## Alternative Monetary Arrangements

Another way to keep governments "honest" is to remove the power to inflate from those with the most incentive to inflate. This is achieved by building in a high level of independence between the central bank—which has the power to inflate—and the Treasury—which has the incentive to inflate. This institutional structure is not a panacea, but has proven especially useful: Studies have shown that countries with more independent central banks have lower inflation rates on average (Alesina and Summers 1993).

The high-inflation era of the 1970s showed us what countries unfettered by fixed exchange rates and dollar convertibility into gold will do left on their own. Addressing this deficiency, the U.S. Congress passed House Concurrent Resolution 133 in 1975, requiring the Federal Reserve to announce annual targets for monetary growth rates. In 1978, the Full Employment and Balanced Growth (Humphrey-Hawkins) Act was passed, requiring the Fed to explain these objectives and any deviations from them. Most major central banks experimented with this form of "instruments monitoring" in the 1970s and 1980s, establishing growth rates for various money measures in an effort to put boundaries on the rate of inflation.

Despite the relatively low inflation rates realized by most industrial countries around the world since 1983, the call for further institutional constraints on central banks is growing. One example is legislation enacted by New Zealand and other countries that the sole objective of central banks is to provide price stability. Similar legislation has recently has been introduced in the U.S. Senate by Connie Mack and Alfonse D'Amato.

Another institutional constraint that can be adopted by smaller countries that lack an established reputation for low inflation is currency boards. The central idea behind currency boards is to look more seriously at the discipline provided by fixed exchange rates. For example, in order to maintain a fixed exchange rate between Argentina and the United States, Argentina's monetary policy must, in essence, be dictated by the United States. If the United States has the credibility to maintain low inflation, the hope is that Argentina's currency board will also achieve credibility over time.

Currency boards are much like a small-scale version of Bretton Woods except that there is no longer a link between the dollar and gold to guarantee that the United States will follow a low-inflation



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policy. Currency boards are probably best described as small boats anchoring themselves to a large ship. As in the Bretton Woods experience, there is not much to keep the smaller boats from drifting if the large ships themselves are not firmly anchored.

Perhaps the most interesting mechanism by which a stable currency might be achieved was proposed by Hayek (1976) in *Denationalisation of Money*. Although central banks, currency boards, and the gold standard each attempt to restrain a government's tendency to inflate, Hayek suggested that governments be removed altogether from the provision of money. He contended that if private currencies are allowed to circulate freely, competition will ensure that the value of these currencies will remain constant. If any issuer attempts to collect too much seigniorage by printing excessive amounts of its currency, consumers will substitute out of that currency into a competing currency with a more stable purchasing power. The offending currency will cease to circulate as money. Thus, currency issuers will have an incentive to remain honest.

Writing 20 years ago, Hayek was clearly ahead of his time. His proposal that governments be completely removed from the money-making business is not likely to come to fruition in the near future. Nevertheless, his basic proposition that competition will provide the necessary incentive to keep people (or countries) honest is relevant today. International currencies are increasingly competing to become the currency of choice. The rapid "dollarization" in Eastern Europe, the former Soviet Union, and Latin America shows how a foreign currency can become a legitimate substitute for a domestic currency that has failed to maintain its value. Even in currency-board countries like Argentina, the ability of individuals to hold dollar accounts provides a strong incentive for the government to maintain its currency board.

Paradoxically, it may be the end of fixed exchange rates and the discipline provided by that system that have allowed internationally competing currencies to flourish. Economists have often cited Gresham's law to argue that money must be provided by governments and not by private banks. This famous dictum states that "bad money will always drive good money out of circulation." This led many to believe that a government monopoly on printing money is necessary.

Recent history teaches us the opposite. As Hayek (ibid.: 31) pointed out,

> Gresham's law will apply *only* to different kinds of money between which a fixed exchange rate is enforced by law. With variable exchange rates, the inferior-quality money would be valued at a lower rate and, particularly if it threatened to fall further in value,



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> people would try to get rid of it as quickly as possible. The selection process would go on towards whatever they regarded as the best sort of money among those issued by the various agencies [or countries], and it would rapidly drive out money found inconvenient or worthless.

But why does a country with credibility not cash it in and inflate to collect extra seigniorage? The answer is clear if we rephrase the question to ask why Mercedes-Benz will not sacrifice quality in exchange for short-term profits.

## Conclusion

The concepts of competitive money, currency boards, or central bank independence were no doubt far from the mind of Abraham Lincoln when he spoke of the government's obligation to provide a stable currency. However, these may be a few of the mechanisms by which a government can ultimately achieve this end. It must be remembered, however, that these different options are not independent. The threat that Argentineans will shift into dollars if Argentina drops its currency board is seen as a strong incentive for the nation to keep it.

The potential that the same competition that has served market economies so well may discipline a country's ability to print money freely is particularly promising. According to Hayek (ibid.: 74), "It might prove to be nearly as difficult for a democratic government not to interfere with money as to regulate it sensibly." He argues that countries around the world should abolish "any kind of exchange control or regulation of the movement of money between countries . . ." and provide "the full freedom to use any of the currencies for contracts and accounting." Further, there should be "the opportunity for any bank located in these countries to open branches in any other on the same terms as established banks" (ibid.: 17).

Laws could be changed in various ways in the United States to foster more effective competition. For example, federal law (Title 31, Section 5103) states that "United States coins and currency (including Federal Reserve notes. . .) are legal tender for all debts, public charges, taxes, and dues. Foreign gold and silver coins are not legal tender for debts." This law might be altered so that contracts written in terms of foreign or alternative domestic monetary units, including specie, could compete with dollars. Twenty years ago, the British House of Lords "ruled that in English courts, foreign creditors could now have their claims recognised in their own currencies" (*The Financial Times*, 6 November 1975).



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Governments must have a role in the enforcement of contracts. As Mises (1949: 780) observed, the laws and courts of a country

> define what the parties to the contract had in mind when speaking of a sum of money. . . . They have to determine what is and what is not legal tender. In attending to this task the laws and the courts do not *create* money. . . . In the unhampered market economy the laws and the judges in attributing legal tender quality to a certain thing merely establish what, according to the usages of trade, was intended by the parties when they referred in their deal to a definite kind of money.

Legislation requiring enforcement of "specific performance" by the courts would increase the opportunity for currency competition. Currently, in most countries of the world, when there is a dispute involving a contract that is stated in terms of a currency or unit (such as gold) other than the national currency, courts will not require performance in the stated unit, but will require that an "equivalent payment" in the national currency be paid.

Money in the 21st century will surely prove to be as different from the money of the current century as our money is from that of the previous century. Just as fiat money replaced specie-backed paper currencies, electronically initiated debits and credits will become the dominant payment modes, creating the potential for private money to compete with government-issued currencies. Such competition between private and governmental monies may help countries around the world to finally live up to Lincoln's challenge of fulfilling "the duty [government] owes the people, of furnishing them a sound and uniform currency."

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# The Argument for Free Markets: Morality vs. Efficiency

*Walter E. Williams*

> Freedom can be preserved only if it is treated as a supreme principle which must not be sacrificed for any particular advantage.
>
> —F. A. Hayek

## Freedom's First Principle

Freedom's first principle is: *Each person owns himself.* The transition from socialism to capitalism and the preservation of capitalism require what philosopher David Kelley calls the entrepreneurial outlook on life, which he describes, in part, as "a sense of self-ownership, a conviction that one's life is one's own, not something for which one must answer to some higher power" (Kelley 1994: 4). Once we accept self-ownership as a first principle, we readily discover what constitutes just and unjust conduct. Unjust conduct is simply any conduct that violates an individual's property rights in himself when he himself has not infringed upon the property rights of others. Therefore, acts like murder, rape, and theft, whether done privately or collectively, are unjust because they violate private property. There is broad consensus that government-sponsored murder and rape are unjust; however, not as much consensus is reached regarding theft. Theft being defined as forcibly taking the rightful property of one person for the benefit of another.

For individual freedom to be viable, it must be a part of the shared values of a society, and there must be an institutional framework to preserve it against encroachments by majoritarian or government will.

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Constitutions and laws alone cannot guarantee the survival of personal freedom as is apparent where Western-style constitutions and laws have been exported to countries not having a tradition of individual freedom. U.S. articulation of the right to individual autonomy is enunciated in our Declaration of Independence:

> We hold these truths to be self-evident, that all men are created equal, that they are endowed by the Creator with certain unalienable rights, that among these are life, liberty and the pursuit of happiness.

That statement, which played such an important role in the rebellion against England and in the establishment of the U.S. Constitution, was the outgrowth of libertarian ideas of such thinkers as John Locke, Montesquieu, and Sir William Blackstone.

Even in societies with a tradition of freedom, such as the United States, the values supporting that freedom have suffered erosion and have proven an insufficient safeguard against encroachment by the state. As is so often the case, political liberty (democracy) has been used to redistribute income and wealth. The redistributive state, in turn, has had a stifling effect on economic liberty and has reduced individual freedom.

Ultimately, the struggle to achieve and preserve freedom must take place in the habits and minds of individuals. And, as admonished by the Constitution of the State of North Carolina (Art. I, Sec. 35), "The frequent reference to fundamental principles is absolutely necessary to preserve the blessings of liberty." It is those fundamental principles that deliver economic efficiency and wealth, not the other way around. Fundamental moral principles or values are determined in the arena of civil society. Values such as thrift, hard work, honesty, trust and cooperative behavior, based on shared norms, are the keys to improving the human condition and provide the undergirding for a free-market economy. Just as important are such social institutions as respect for private property, sanctity of contracts, educational institutions, clubs, charities, churches, and families. All those institutions provide the glue to hold society together in terms of common values and provide for the transmission of those values to successive generations. Too often informal institutions and local networks are trivialized and greater favor is given to the intellectual's narrow conception of what constitutes knowledge and wisdom.

The importance of informal networks such as friends, church members, neighbors, and families cannot be underestimated—as demonstrated in the following example of small proprietorships.[1] The critical

[1]The example is taken from Thomas Sowell (1980: 25).



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determinants of a proprietor's success are perseverance, character, ability, and other personal characteristics. Banks seldom finance the establishment of such business. Most small businesses are financed through friends and family. The reason is that those are the people who have the lowest cost in acquiring the necessary information about the proprietor's characteristics deemed critical for success. Also, friends and family, who lend the proprietor money, have a personal stake in the business and have an incentive to moderate their likely bias in favor of the borrower. Clearly, a formal lending institution could query friends and relatives. However, the information obtained would have greater bias because friends and relatives would not have sufficient stake in the business to offset any personal bias they had in favor of the borrower.

## Institutions and Wealth

F. A. Hayek refers to the rules of several property determined by traditions and values. Those rules consisted in what David Hume called "the stability of possessions," "transference by consent," and "the keeping of promises" (Hayek 1984: 321). Nations that have respected the rules of several property have produced social and economic climates far more conducive to the welfare of their citizens than nations that have failed to respect property rights. People in countries with larger amounts of economic freedom, such as the United States, Canada, Australia, Hong Kong, Japan, and Taiwan are far richer and have greater human rights protections than people in countries with limited free markets such as Russia, Albania, China, and every country in Africa.

The role of private property and free markets in creating wealth is often overlooked. Factors such as natural-resource endowment, population size, and previous conditions (colonialism) are claimed to explain wealth. Yet those factors cannot explain human betterment. The United States and Canada have relatively small populations, abundant natural resources, and are wealthy. However, if low population density and abundant natural resources were adequate explanations of wealth, one would expect the former Soviet Union and countries on the continents of Africa and South America to be wealthy. Instead, the former Soviet Union, Africa, and South America are home to many of the world's poorest and most miserable people.

A history of colonialism is often given as an excuse for poverty but that is a bogus hypothesis. The world's richest country, the United States, was formerly a colony. Canada, Australia, and New Zealand were colonies—and Hong Kong remains a colony. A far better explana-



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tion of wealth are the values and traditions that produce the rules of several property. Economics is not an independent variable whose laws are unaffected by the institutional framework within which it operates. Economic efficiency is a by-product of pre-existing cultural and moral norms.

## The Intellectual Defense of Liberty

All too often defenders of free-market capitalism base their defense on the demonstration that capitalism is more efficient in terms of resource allocation and, hence, leads to a larger bundle of goods than socialism and other forms of statism. However, as Milton Friedman frequently points out, economic efficiency and greater wealth should be promoted as simply a side-benefit of free markets. The intellectual defense of free-market capitalism should focus on its moral superiority. In other words, even if free enterprise were not more efficient than other forms of human organization, it is morally superior because it is rooted in voluntary relationships rather than force and coercion, and it respects the sanctity of the individual.

The wealth created by free-market capitalism also cultivates civil society. For most of human history, individuals have had to simply eke out a living. With the rise of capitalism and the concomitant rise in human productivity, people were able to satisfy their physical needs with less and less time. Economic progress made it possible for people to have the time to develop spiritually and culturally. The rise of capitalism enabled the gradual extension of civilization to greater and greater numbers of people. As the wealth of nations grew, people had the means to become educated in the liberal arts and to gain greater knowledge about the world around them. The rise of capitalism enabled ordinary people to attend the arts, afford recreation, and contemplate more fulfilling and interesting life activities, and engage in other culturally enriching activities that were formerly only within the purview of the rich.

## Demystification of the State

A. V. Dicey (1914: 257) wrote:

> The beneficial effect of State intervention, especially in the form of legislation, is direct, immediate, and so to speak visible, whilst its evil effects are gradual and indirect, and lie outside our sight. . . . Hence the majority of mankind must almost of necessity look with undue favour upon government intervention. This natural bias can be counteracted only by the existence, in a given society, . . . of a presumption or prejudice in favour of individual liberty, that is of *laissez-faire*.



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One can hardly determine the casualties of war simply by looking at survivors. We must ask what happened to those whom we do not see. Similarly, when evaluating interventionist public policy we cannot evaluate it simply by looking at its beneficiaries. We must discover its victims. Most often the victims of public policy are invisible. To garner greater public support against government command and control, we must somehow find a way to make those victims visible.

In all interventionist policy there are those who are beneficiaries and those who are victims. In most cases the beneficiaries are highly visible and the victims are invisible. A good example is the minimum wage law. After enactment of an increase in the minimum wage law, politicians accompanied by television crews readily point to people who have benefitted from the legislation. The beneficiaries are those with a fatter paycheck. Thus, the politician can lay claim to the wisdom of his legislation that increased minimum wages. Moreover, the politician is also a beneficiary since those now earning higher wages will remember him when election time comes around. By parading minimum wage beneficiaries across the stage, those who oppose minimum wage increases can be readily portrayed as having a callous, mean-spirited disregard for interests of low-wage workers.

A political strategy of those who support liberty should be that of exposing the invisible victims of minimum wage laws. We need to show those who have lost their jobs, or do not become employed in the first place, because their productivity did not warrant being employed at the minimum wage. We should find a way to demonstrate jobs destroyed by minimum wages such as busboys, gasoline station attendants, and movie ushers. We must show how marginally profitable firms have been forced out of business, though surviving firms may have the same number of employees. We should show how capital was artificially substituted for labor as a result of higher mandated wages and how firms have adjusted their production techniques in order to economize on labor. The particular adjustments firms make in response to higher mandated wages are less important than the fact that adjustments will be made.

A more dramatic example of the invisible victims of interventionist state policy can be found in the regulation of medicines and medical devices, as in the case of the Food and Drug Administration (FDA) in the United States. Essentially, FDA officials can make two types of errors. They can err on the side of undercaution and approve a drug with dangerous unanticipated side effects. Or they can err on the side of overcaution, not approving a useful and safe drug, or creating costly and lengthy drug approval procedures.



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Errors on the side of undercaution lead to embarrassment and possibly loss of bureaucratic careers and promotions because the victims of unsafe drugs will be visible through news stories of sick people, congressional investigations, and hearings. However, errors on the side of overcaution, through extensive delay in the approval of drugs—as in the cases of propranolol, Septra, and other drugs—impose virtually no costs on the FDA. Victims of FDA errors on the side of overcaution are mostly invisible to the press, the public, and politicians.

Those victims should be made visible. Once the FDA (or some other approving agency) approves a drug widely used elsewhere with no untoward effects, we should find people who died or needlessly suffered as a result of the FDA's delay. For political efficiency we cannot simply offer intellectual arguments. We must get pictures and stories of FDA victims in an effort to appeal to a sense of fair play, decency, and common sense among the citizenry. But there is also a role for intellectual arguments in the sense of teaching people that any meaningful use of "safe" must see safety as a set of tradeoffs rather than a category. The attempt to get a "safe" drug means that people will die or needlessly suffer during the time it takes to achieve greater safety. That toll must be weighted against the number of people who might die or become ill because of the drug's earlier availability and attendant unanticipated harmful side effects. People should also be taught to understand that if a 100 percent safe drug is ever achieved, it will be the *only* thing in this world that is 100 percent safe.

Another area of state interventionism, which particularly applies to less developed nations, is restrictive import laws and regulations. Restricting foreign imports as a means to save jobs sounds plausible. Adding to the appeal of restrictive trade policy is the fact that its beneficiaries are highly visible while its victims are invisible.

Using an example of the American experience may suggest a political strategy. Most people fully understand that import restrictions raise the cost of products but may have little understanding of its systemic effects. Arthur Denzau of the Center for the Study of American Business found that "voluntary restraints" on imported steel saved nearly 17,000 jobs in the steel industry. However, the higher steel prices, resulting from the restraints, led to a loss of 52,000 jobs in American *steel-using* industries. On balance steel restrictions led to a net loss of 35,400 jobs (Denzau 1987: 12). The process is easy to understand. Caterpillar Company uses steel to produce heavy construction equipment. Trade restrictions caused higher steel prices that in turn raised Caterpillar's production costs. Higher costs made



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Caterpillar less competitive in both domestic and international markets, which led Caterpillar to downsize its labor force. As a result, we see more Japanese and Korean-produced heavy equipment in the United States. Importing finished products, by the way, is just another way to import steel.

In addition to causing a net loss of jobs, trade restrictions are costly to consumers. According to estimates, the Reagan administration's "voluntary import restraints" on Japanese cars increased the price of Japanese cars sold in the United States by $900 and increased the price of U.S. cars by $350, for a total cost to American consumers of $4.3 billion. That price tag translates into a cost of $200,000 per year for each job saved in Detroit (Tarr and Morkre 1984: 57). It would have been cheaper to have given each Detroit auto worker, laid off by freer trade, a check for $60,000 a year so they could buy a vacation residence in Miami. That way, collectively, we would have been better off to the tune of $140,000 per job saved. Of course, that policy choice would not have been politically feasible because the costs would have been apparent and taxpayers would have refused to pay for the free vacation. It is not only auto workers with whom the nation could have made the trade. According to the Federal Trade Commission, quotas on textile products from Hong Kong cost consumers $34,500 per year for each job saved for American textile workers earning $7,600 to $10,700 annually (Morkre 1984: 27).

Identifying the invisible victims of trade restrictions may suggest a political strategy to fight such restrictions. One such strategy is to organize companies adversely affected by import restrictions, such as steel-using companies in the case of the U.S. import restrictions on steel.

## Justice: Process vs. Results

At the heart of most interventionist policy is a vision of justice. Most often this vision evaluates the presence of justice by looking at results.

Social justice has considerable appeal and as such is used as justification for interventionist statism. There are several criticisms of the concept of social justice that Hayek has answered well, but defenders of personal liberty must make a greater effort to demystify the term and show that justice or fairness cannot be determined by examining results. The results people often turn to in order to determine the presence or absence of justice are educational and occupational status, income, life expectancy, and other socioeconomic factors. But justice or fairness cannot be determined by results. It is a process question.



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Consider, for example, that three individuals play a regular game of poker. The typical game outcome is: individual A wins 75 percent of the time, while individuals B and C win 15 percent and 10 percent of the time, respectively. By knowing the game's *result*, nothing unambiguous can be said about whether there has been "poker justice." Individual A's disproportionate winnings are consistent with his being an astute player, clever cheater, or just plain lucky. The only way one can determine whether there has been poker justice is to examine the game's *process*. Process questions would include: Did the players play voluntarily? Were the poker rules neutral and unbiasedly applied? Was the game played without cheating? If the process were just, affirmative answers would be given to those three questions and there would be poker justice irrespective of the outcome. Thus, justice is really a process issue.

The most popular justification for the interventionist state is to create or ensure fairness and justice in the distribution of income. Considerable confusion, obfuscation, and demagoguery regarding the sources of income provide statists with copious quantities of ammunition to justify their redistributionist agenda. Income is not distributed. In a free society, income is earned. People serving one another through the provision of goods and services generate income.

We serve our fellow man in myriad ways. We bag his groceries, teach his children, entertain him, and heal his wounds. By doing so, we receive "certificates of performance." In the United States, we call these certificates dollars. Elsewhere they are called pesos, francs, marks, yen, and pounds. Those certificates stand as evidence (proof) of our service. The more valuable our service to our fellow man (as he determines), the greater the number of certificates of performance we receive and hence the greater our claim on goods and services. That free-market process promotes a moral discipline that says: Unless we are able and willing to serve our fellow man, we shall have no claim on what he produces. Contrast that moral discipline to the immorality of the welfare state. In effect the welfare state says: You do not have to serve your fellow man; through intimidation, threats, and coercion, we will take what he produces and give it to you.

The vision that sees income as being "distributed" implies a different scenario for the sources of income never made explicit. The vision that sees income as being distributed differs little from asserting that out there is a dealer of dollars. It naturally leads to the conclusion that if some people have fewer dollars than others, the dollar dealer is unfair; he is a racist, sexist, or a multi-nationalist. Therefore, justice and fairness require a re-dealing (income redistribution) of dollars. That way the ill-gotten gains of the few are returned to their "rightful"



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owners. That vision is the essence of the results-oriented view of justice underpinning the welfare state.

People who criticize the existing distribution of income as being unfair and demand government redistribution are really criticizing the process whereby income is earned. Their bottom line is that millions of individual decisionmakers did not do the right thing. Consider the wealth of billionaire Bill Gates, the founder of MicroSoft. Gates earned billions because millions of individuals *voluntarily* spent their money on what they wanted—his products. For someone to say that Gates's income is unfair is the same as saying that the decisions of millions of consumers are wrong. To argue that Gates's income should be forcibly taken and given to others is to say that somehow third parties have a right to preempt voluntary decisions made by millions of traders.

When sources of income are viewed more realistically, we reach the conclusion that low income, for the most part, is a result of people not having sufficient capacity to serve their fellow man well rather than being victims of an unfair process. Low-income people simply do not have the skills to produce and do things their fellow man highly values. Seldom do we find poor highly productive individuals or nations. Those who have low incomes tend to have low skills and education and hence low productive capacity. Our challenge is to make those people (nations) more productive.

Another explanation of low income is that the rules of the game have been rigged. That is, people do have an ability to provide goods and services valued by their fellow man but are restricted from doing so. Among those rules are minimum wage laws, occupational and business licensure laws and regulations, and government-sponsored monopolies. Hence, another argument for free-market capitalism is that it is good for low-income, low-skilled people.

## The Vision of Black Markets

We should always keep in mind the resiliency of markets. Despite the efforts of socialist regimes, markets tend to survive to one degree or another; they are an irrepressible part of human nature. As Adam Smith ([1776] 1976: 17) wrote, "It is the necessary . . . certain propensity in human nature . . . to truck, barter, and exchange one thing for another." During the 70 years of the Soviet experiment, with massive attempts to suppress markets (including jail, banishment, and death), markets in one form or another survived. The conditions for the formation of markets are always present and explain their resiliency. Those conditions are: (1) private ownership of property, (2) interaction

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between people who place different valuations on goods, and (3) individual will and self-interest.

Those conditions give rise to markets be they legal or illegal (black) markets. According to some estimates, up to 84 percent of the Soviet people purchased goods and services through the black market or *fartsovshiki*. The *fartsovshiki* was also a source of additional employment, and hence income, for as many as 20 million Soviet citizens (Galuszka 1989). According to *Automotive News* (1985), 60 percent of Soviet citizens used black-market mechanics for auto repairs and another 30 percent purchased gasoline and parts from black-market distributors.

Soviet officials could never eliminate black markets and one doubts that they wanted to. After all, the Soviet system may have survived as long as it did because some of its more uglier consequences were mitigated by the presence of black markets. Given the periodic shortages of life's necessities such as food and clothing, there may have been uncontrollable social disorder if Soviet citizens had to do without rather than have a black-market outlet to which they could turn to for relief.

The Soviet experience proves that man is by nature a capitalist. The transition from socialism to capitalism requires only that human nature be permitted to flourish.

## Conclusion

The struggle to extend and preserve free markets must have as its primary focus the moral argument. State interventionists stand naked before well-thought-out moral arguments for private ownership of property, voluntary exchange, and the parity of markets. People readily understand moral arguments on a private basis—for example, one person does not have the right to use force against another to serve his own purposes. However, people often see government redistribution as an acceptable use of force. In a democratic welfare state that coercion is given an aura of legitimacy. The challenge is to convince people that a majority vote does not establish morality and that free markets are morally superior to other forms of human organization.

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# The Case against Civil Ex Post Facto Laws

*Steve Selinger*

According to Article I, Section 10 of the Constitution, "no State shall pass any ex post facto Law." A similar provision that applies to Congress is found in Section 9 of the same article. At first glance these constitutional prohibitions seem simple enough—retroactive laws violate the Constitution. Unfortunately, the issue is not so simple. With one ruling in 1798, the Supreme Court succeeded in muddling the issue of ex post facto laws by holding that the prohibition of retroactive laws applies only to criminal, not civil, laws.

In *The Constitution of Liberty*, F. A. Hayek (1960: 205–20) notes that some coercion, while unavoidable in a civil society, can be minimized by requiring that coercive actions comply with general rules that are known in advance by individuals. If individuals know the law, they can base their actions upon established rules and minimize the ill effects of coercion. Hayek states that not all legislative enactments will satisfy the three criteria of what he calls "true law"—generality, certainty, and equality. He argues that true law provides the general rules which minimize coercion and that legislative enactments which do not satisfy these criteria are objectionable. He writes that the law must be general, that it must be known and certain, and that it should apply equally to all. A necessary condition for the law to be known and certain is a prohibition on ex post facto laws. After all, the law can hardly be known and certain if new laws can be made to apply retroactively to actions already performed.

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From a policy standpoint, as Hayek's analysis indicates, ex post facto laws are riddled with problems. Unfair and unpredictable, ex post facto or retroactive laws mar the American legal system and create an abundance of problems.[1]

This article examines the origins of the constitutional interpretation of ex post facto laws, reviews sources favoring the prohibition of ex post facto civil laws, considers the damaging impact of retroactive laws on property rights, and proposes a solution to the debate over retroactive laws in which ex post facto civil as well as criminal laws would be constitutionally prohibited unless just compensation is provided for unfair retroactivity. Given that the clear constitutional ban on ex post facto laws does not distinguish between criminal and civil laws and given our own intuitions about fairness in the legal system, the prohibition on ex post facto laws should be extended to civil laws in order to prevent unfair and capricious changes in the law.

## *Calder v. Bull*: Origins of the Distinction between Civil and Criminal Ex Post Facto Laws

The Supreme Court first held that the constitutional prohibition against ex post facto laws applied only to criminal laws in the landmark opinion of *Calder v. Bull* (1798). The issue in the case, which arose from the Supreme Court of Connecticut, was whether the act of the Connecticut legislature to set aside a decree of a probate court (which had the effect of divesting the appellants of certain property) was an ex post facto law.

The matter involved rights obtained under a will. Calder had obtained the right to possession of certain property via a probate court ruling, from which there was no right of appeal. The Connecticut legislature then passed a law setting aside the decree of the probate court and allowing a new hearing and a right of appeal. On rehearing, the probate court found in favor of Bull. On Calder's appeal to the Supreme Court, he argued that the law passed by the Connecticut

[1]The dangers of ex post facto laws can be found in many contemporary contexts. On January 19, 1996, the Supreme Court agreed to hear the Justice Department's challenge of a federal appeals court ruling in *U.S. v. Winstar* that the government breached its promise to savings and loan institutions in 1989 when it revised accounting laws by unilaterally rescinding a 40-year goodwill amortization period. With approximately 100 similar cases pending against the government, the government could be liable for as much as $10 billion if the Court upholds the lower court's ruling in favor of the plaintiff, Glenfed, Inc. In this case, a retroactive change in accounting contributed to the failure of many savings and loan institutions. This is more than a breach of contract matter; it is a clear example of the disastrous effects of ex post facto laws, a point that the respondents may explore in their argument before the Supreme Court.



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legislature was an ex post facto law and therefore prohibited by Article 1, Section 10 of the Constitution, which states in part that no state shall pass any "ex post facto law."

Surprisingly, the Supreme Court rejected Calder's approach, holding that the constitutional prohibition of ex post facto laws applied only to criminal laws. In an opinion written seriatim by Justices Samuel Chase, William Paterson, and James Iredell, Justice Chase acknowledged that the right to certain property had been awarded to Calder as a result of the probate court decision. However, due to a subsequent law, the new hearing of the matter in the probate court, and the resulting decision, Calder's right to recover that property was negated and the property rights were awarded to Bull. According to Justice Chase, the law that took away Calder's right to that property was not an ex post facto law. Ironically, Justice Chase also acknowledged that there are certain laws that a legislature may not constitutionally enact, among them being "[a] law that takes property from A and gives it to B" (*Calder*: 388). Although it seems obvious that this language applies to the facts of *Calder*, the Court did not view it that way.

In his reasoning, Justice Chase cited Article I, Section 10 of the Constitution, which contains the ex post facto prohibition, and pointed out that it also prohibits: (1) the making of anything but gold and silver coin a tender in the payment of debts, and (2) the passage of any law impairing the obligations of contracts. According to Justice Chase, those two provisions were inserted to secure private rights. Chase reasoned that if the prohibition against making ex post facto laws had been intended to secure personal rights from being affected or injured by such laws, and the prohibition against ex post facto laws was sufficiently extensive for that object, then the listing of the coin and contract restraints was redundant.

Justices Paterson and Iredell concurred with Justice Chase. Justice Paterson argued that the bar on the impairment of contracts suggested that the framers of the Constitution intended the prohibition on ex post facto laws to include "crimes, pains, and penalties, and no further." According to Justice Iredell, the purpose of the ex post facto clause did not extend to "civil cases, to cases that merely affect the private property of citizens" (*Calder*: 400).

Strangely enough, while *Calder* has been discussed at length by legal historians, the essential logic of the Court's decision appears to have been ignored. Most discussions of the case have been historical inquiries concerning how "ex post facto" was used when the Constitution was first written. Such inquiries have shown that the prohibition on ex post facto laws was probably not intended to be restricted to criminal laws (e.g., Field 1920, Smead 1936). Perhaps the most

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thorough treatment of ex post facto laws can be found in William Crosskey's *Politics and the Constitution* (1953). Although Crosskey criticizes the *Calder* decision, he does not appear to address directly the Court's chief argument.

According to Crosskey (1953: 351), following the *Calder* decision, Supreme Court Justice William Johnson sought to persuade a later Court that *Calder* had been wrongly decided. In dissecting and refuting the reasons for the *Calder* decision, Johnson wrote in *Satterlee v. Matthewson* (1829):

> It is obvious, in the case of *Calder v. Bull*, that the great reason which influenced the opinion of the three judges who gave an exposition of the phrase "ex post facto" was that they considered its application to civil cases as unnecessary, and fully supplied by the prohibition to pass laws impairing the obligation of contracts.

Justice Johnson went on to assert that the class of civil ex post facto laws was broader than the simple class of laws impairing the obligation of contracts. As such, he answered that it would not suffice to equate the prohibition against civil ex post facto laws with the prohibition against laws impairing contracts. According to Justice Johnson,

> The learned judges could not then have foreseen the great variety of forms in which the violation of private right have since been presented to this Court. The case of a legislature declaring a void deed to be a valid deed, is a striking one to show, both that the prohibition to pass laws violating the obligation of contracts is not a sufficient protection to private rights; and that the policy and reason of the prohibition to pass ex post facto laws does indeed extend to civil as well as criminal cases [*Satterlee*: 685].

Unfortunately, Justice Johnson's reply to the *Calder* opinion misinterprets the Court's argument. The Court in *Calder* did not argue that civil ex post facto laws need not be prohibited because of the existence of the Contracts Clause, as Johnson interprets them as saying. The majority did not say or assume that the prohibition against civil ex post facto laws was unnecessary because the prohibition against laws impairing contracts covered all possible civil ex post facto laws.

Rather, the *Calder* majority argued that the prohibition on ex post facto laws could not have been meant to apply to civil laws because the addition of the prohibition on laws impairing contracts would have been superfluous. Since laws impairing contracts are a subclass of civil ex post facto laws, if all civil ex post facto laws are outlawed, it is unnecessary to further outlaw this subclass of ex post facto laws. Hence, the *Calder* Court reasoned, the prohibition cannot have been meant to apply to all civil ex post facto laws. It is this argument, and


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not the one that Johnson misinterprets the Court as making, that must be addressed.

The *Calder* majority's argument is easily refuted with the reasoning that there is nothing inconsistent with interpreting the ex post facto prohibition as applying to all laws, including civil laws. For example, Article I, Section 10 of the Constitution prohibits states from making legal tender out of anything but gold and silver coins and there is a constitutional prohibition against laws impairing contracts. These examples are illustrative of the prohibition against ex post facto laws, but do not encompass all possible ex post facto laws. If two individuals have a binding contract, and a legislature then passes a law abrogating the contract, an ex post facto law has been applied to the contract. Similarly, if two individuals make an agreement that a debt shall be paid in gold or silver, and a legislature passes a law saying that newly created paper money shall suffice for the payment of the debt, an ex post facto law has been applied to them.

An action can be prohibited by both a general and a more specific clause of the Constitution. For instance, a law substituting paper money for gold and silver tender would be prohibited by both the contracts clause and the gold and silver clause. Strictly speaking, the clause in the Constitution forbidding laws that impair contracts by substituting other legal tender in place of gold and silver is unnecessary as it is covered by the more general contracts clause. Yet no one would argue that the contracts clause should not apply to other laws that seek to change standards for legal tender and impair contracts. For instance, a law impairing contracts to pay in platinum would still be unconstitutional even though only gold and silver are mentioned in the legal tender clause; the inconsistency with the more general contracts clause would still be sufficient to render the law unconstitutional.

Similarly, while a law impairing contracts is one specific type of ex post facto law, as the Court correctly pointed out, it is not the only type of ex post facto law. Interpreted in this way, there is nothing inconsistent in applying the prohibition against ex post facto laws to other civil laws. The other two clauses mentioned in the Constitution are merely examples of more specific types of ex post facto laws that are prohibited.

The Court seems to have been guided in its logic by the maxim that the "specific controls the general," a maxim that is enshrined in California Civil Code §3354, which states, "[p]articular expressions qualify those which are general." It is true that if there is a conflict between a more specific statute and a general one, the specific one controls. Where there is no conflict, however, a general provision is

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still applicable (as the examples of the contracts clause and legal tender clause show).

This position is buttressed by the fact that the Constitution does not explicitly prohibit Congress from passing laws impairing the obligation of contracts. Regarding Congress, the Constitution merely states that "Congress shall pass no bills of attainder or ex post facto laws." It is in the subsequent section, regarding prohibitions on laws the states may pass, that the more specific clauses referencing the prohibition on laws impairing the obligation of contracts and legal tender are found.

It is thus problematic to base an argument against the application of the ex post facto clause to civil law on the existence of the contract and legal tender clauses (as the *Calder* Court does), because those clauses do not even appear in the section of the Constitution restricting laws that Congress can make. By the logic in *Calder* it would follow that Congress is not free to pass civil ex post facto laws. Yet this logic gives us the strange result that states can pass civil ex post facto laws (because of the existence of the contract and legal tender clauses) while Congress cannot pass civil ex post facto laws (because the prohibition on ex post facto laws with respect to Congress is not accompanied by the contract and legal tender clauses).

The second argument that Justice Chase makes in *Calder* is that state constitutions constructed before the U.S. Constitution explicitly prohibited criminal ex post facto laws (*Calder*: 391). The Massachusetts Constitution, for instance, refers to "laws made to punish actions done before the existence of such laws," while the Maryland Constitution refers to "laws punishing facts committed before the existence of such laws."

William Crosskey (1953: 342–51) convincingly shows that Justice Chase's argument in *Calder* about state constitutions is flawed. Justice Chase quotes from some of the referenced state constitutions, misquotes others, and ignores the New Hampshire Constitution, which expressly applied a prohibition against ex post facto laws to both civil and criminal laws. Crosskey notes the various state and federal circuit-court cases that, until *Calder*, had interpreted the prohibition as applying to civil as well as criminal laws.

Although Crosskey's historical arguments are persuasive, it is also worth noting that the Court's arguments in *Calder* are logically problematic. Even if we grant the Court's position that the majority of state constitutions at the time did reference ex post facto laws in an explicitly criminal context, that fact fails to prove the *Calder* majority's contention that the prohibition of ex post facto laws in the U.S. Constitution was intended to apply only to criminal laws. Unlike ex post facto clauses in some state constitutions, the one in the U.S. Constitution does not contain an explicit reference to criminal laws.



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In that case, the legislatures of the time chose not to limit the application of the ex post facto clause to criminal acts through explicit language, although they clearly knew how to create an express limitation. The Court should not presume to insert such language when a legislature (or constitutional convention) has chosen to withhold the language. It thus seems that the Court's own remarks about the state constitutions of the time (even if such constitutions had been correctly and fully quoted) do not justify its conclusion that ex post facto laws apply only in a criminal context. If anything, they serve to prove just the opposite point.

## Sources Favoring the Prohibition of Civil Ex Post Facto Laws

### *The Federalist Papers: Favoring Regular Course of Business*

Beyond the flawed logic of *Calder*, there are many sources of support for the prohibition of civil ex post facto laws. The *Federalist Papers*, written in support of the Constitution, may provide guidance as to the intended meaning of the term "ex post facto" in the Constitution. The *Federalist Papers* refer to ex post facto laws in both the civil and criminal context. The authors intended for the prohibition of ex post facto laws to extend to civil laws as well as criminal laws, as James Madison noted in *Federalist* No. 44:

> Bills of attainder, ex-post facto laws, and laws impairing the obligation of contracts are contrary to the first principles of the social compact, and to every principle of sound legislation. . . . [T]he sober people of America are weary of the fluctuating policy which has directed the public councils. They have seen with regret and indignation that sudden changes and legislative interferences, in cases affecting personal rights, become jobs in the hands of enterprising and influential speculators, and snares to the more industrious and less informed parts of the community. They have seen, too, that one legislative interference is but the first link of a long chain of repetitions, every subsequent interference being naturally produced by the effects of the preceding. They very rightly infer, therefore, that some thorough reform is wanting, which will banish speculations on public measure, inspire a general prudence and industry, and give a regular course to the business of society.

The references to "prudence and industry" and giving a "regular course to the business of society" suggest that the constitutional prohibition against ex post facto laws should be seen as applying to both civil and criminal laws because of public policy reasons. In *Federalist* No. 84, Madison also refers to criminal laws:

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> The establishment of the writ of habeas corpus, the prohibition of ex-post-facto laws, and of titles of nobility, to which we have no corresponding provision in our Constitution, are perhaps greater security to liberty and republicanism than any it contains. The creation of crimes after the commission of the fact, or . . . the subjecting of men to punishment for things which, when they were done, were breaches of no law . . . have been, in all ages, the favorite and most formidable instruments of tyranny.

Taken together, these passages strongly suggest that the authors of the *Federalist Papers* intended the prohibition against ex post facto laws to apply to both civil and criminal laws.

*The Obscure Line Between Criminal and Civil Laws*

An additional concern regarding the retroactive application of civil laws is that the distinction between civil and criminal laws is frequently discretionary. For example, both the Internal Revenue Service and the Securities and Exchange Commission can often choose to file suit on either a civil or criminal basis. State and local governments also have this discretion in many areas. Although there are important differences between criminal and civil laws, in the context of ex post facto laws it makes no sense to protect against criminal but not civil ex post facto laws. With either type, when the offending act was performed, it was not prohibited. Why should there be less protection against an ex post facto law if someone is sued on civil rather than criminal charges?

It might be thought that criminal laws can be distinguished from civil laws because violations of criminal laws, unlike civil laws, can be punished with physical incarceration. This reasoning fails, however, because incarceration as punishment for violation of civil law was prevalent in colonial times when the Constitution was drafted. For example, there were debtor prisons that required incarceration for nonpayment of debt. In fact, the existence of debtor prisons at the time of the Constitution shows that there was no hard and fast distinction between civil and criminal laws and is one more argument for applying the prohibition against ex post facto laws to civil laws.[2]

*Due Process Concerns: Inconsistent Standards for Retrospective versus Prospective Legislation*

While the Supreme Court has not issued a blanket prohibition against civil ex post facto laws, it has recognized that retroactive laws

[2]Crosskey (1953: 349) indicates that the real motivation of the *Calder* Court to allow ex post facto civil laws was to grant bankruptcy relief for debtors, as one of the former Justices was in hiding and trying to avoid debtor's prison.



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do present real problems of fairness. *General Motors Corp. v. Evert Romein* (1992) involved the constitutionality of a law passed by the Michigan legislature that required automobile companies to pay certain worker benefits retroactively. That law was passed to undo a Michigan Supreme Court decision (interpreting a previous Michigan worker's compensation statute) that said benefits were not to be paid retroactively. General Motors and Ford sued on the grounds that requiring new benefits to be paid retroactively violated the contracts clause. The Court held that the parties never explicitly bargained for the required benefits. Hence, the Court held that there was no violation of the contracts clause and that the ex post facto law that required new benefits to be paid retroactively was constitutional.

The *General Motors* case would have been easy if the prohibition on civil ex post facto laws was intact: the subject law was obviously retroactive and would have been prohibited. Instead, General Motors and Ford had to pay an additional $25 million in retroactive benefits. Justice Sandra Day O'Connor identified the unfairness of retroactive legislation (*General Motors*: 320):

> Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions. For this reason, "the retroactive aspects of economic legislation must meet the test of due process"—a legitimate legislative purpose furthered by rational means.

Unfortunately, the due process standard of "a legitimate legislative purpose furthered by rational means" is so easily satisfied that it renders any due process constraints against retroactive laws of very dubious use. Virtually any law passed by a majority can be said to satisfy a legitimate legislative purpose. Similarly, a test for "rational means" is vague. An activist court can second-guess the legislature and make the rational means standard difficult to satisfy, while a court of judicial restraint can decide that any piece of legislation satisfies the rational means standard.

The whole purpose behind the prohibition on ex post facto laws, as the *Federalist Papers* note, is to give a regular course to the business of society and banish speculations on public measures. Allowing interest groups to lobby a legislature to pass ex post facto laws, and abiding by the results so long as they pass the basically standardless criteria of "a legitimate legislative purpose furthered by rational means," does not provide the regular course to business that the Founders intended when they included the constitutional prohibition on ex post facto laws.

It is interesting to contrast the due process standard with respect to vagueness with the due process standard regarding retrospective



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legislation. Regarding vagueness, the Court has held in cases such as *Grayned v. City of Rockford* (1972) that government regulation must be sufficiently clear so that ordinary people can understand what conduct is being prohibited. In *Village of Hoffman Estates v. The Flip Side, Hoffman Estates, Inc.* (1982: 498), the Court held that although "economic regulation is subject to a less strict vagueness test" than criminal laws, vagueness analysis still applies. The Court gave two reasons for such a lesser standard. First, "because its subject matter is often more narrow, and because businesses can be expected to consult relevant legislation in advance of action" (ibid.). Second, because "the regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process" (ibid.: 455).

It should be clear that neither of these considerations supports the application of retroactive laws to economic legislation. First, business will not be able to consult relevant legislation in advance since the legislation is retroactive. Second, business will not be able to clarify the meaning of the regulation by resorting to administrative processes, because the retroactive legislation does not even exist at the time.

The contrast between what due process requires of retroactive and prospective legislation is stark. Due process requires that retrospective legislation meet the vague criteria of a "legitimate legislative purpose furthered by rational means." With respect to prospective legislation, on the other hand, due process requires that an ordinary citizen be able to know what is proscribed by a law. Barring clairvoyant abilities, the ordinary citizen will not know what behavior, including economic behavior, is proscribed by retroactive legislation. That is, retroactive legislation will certainly not be able to satisfy the due process standard required for prospective legislation. This seems an altogether unsatisfactory state of affairs. It makes no sense for due process to require that legislation be sufficiently clear so that an ordinary person must know what is proscribed in advance, and yet for due process to allow that same individual to become befuddled by retroactive laws that were impossible to know at the time of his or her actions.

## United States v. Carlton: *Modern Difficulties of Civil Ex Post Facto Laws*

Recently, the Supreme Court unanimously held that retroactive tax laws were constitutional in *United States v. Carlton* (1994). While acting as an estate executor, Carlton relied upon a provision of the Tax Reform Act of 1986 that gave companies a favorable deduction from the proceeds of sale of a company's securities to its Employee Stock Ownership Plan. The government then proceeded to retroac-


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tively deny this favorable deduction by amending the 1986 law. The court of appeals in *Carlton* struck down the amended law as unconstitutional after finding that the estate had detrimentally relied upon the 1986 law and had no notice of the impending change. The court of appeals also cited the fact that retroactive income tax laws have been allowed but only for the year of enactment and the year prior to enactment (thus about a two-year limit). This decision was the first such invalidation of a retroactive tax law in almost half a century.

The Supreme Court, however, reversed the decision by the Court of Appeals for the Ninth Circuit and found that due process was not violated by retroactive application of the amended tax statute. According to the Court, the retroactive application of the tax amendment was consistent with the Fifth Amendment's due process clause because: (1) The purpose of the congressional amendment, which was to avoid a significant and unplanned federal revenue loss, was neither illegitimate nor arbitrary; (2) Congress acted promptly and established the retroactivity for only a short duration; (3) Carlton's reliance was insufficient to establish a constitutional violation; and (4) Carlton's lack of notice regarding the retroactive changes was not dispositive.

Although the vote was unanimous, Justice Antonin Scalia expressed misgivings about retroactivity in his concurring opinion, which Justice Clarence Thomas joined. Justice Scalia expressed reluctance to endorse the ineffective standard of a "legitimate legislative purpose furthered by rational means," although Scalia nevertheless concurred with the majority because of his distrust of the concept of "substantive due process." After castigating the "bait and switch" policy represented by retroactive taxation, Justice Scalia still upheld retroactive taxation, although it is clear from his remarks regarding "bait and switch" taxation that he did not feel comfortable ratifying the government's arbitrary conduct. Indeed, Scalia's opinion reads more like a dissent.

In his opinion, Justice Scalia labeled the term "substantive due process" an oxymoron. Although he does not elaborate, his idea seems to be that any substantive right cannot by definition be protected by a formalistic, procedural concept such as "due process." Scalia skeptically notes that substantive due process has been used to invent rights such as the right to abortion in *Roe v. Wade* (1973) and the right to decide family living arrangements in *Moore v. East Cleveland* (1977) that he cannot find in the original constitution. Ultimately, Justice Scalia also rejects the expansion of substantive due process rights in the context of *Carlton*.

The legal brief presented to the Court for Carlton did not advance a frontal challenge to the constitutionality of civil ex post facto legisla-

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tion. In fact, *Calder v. Bull* was not even mentioned in the brief. Rather, Carlton argued that the retroactive taxation violated substantive due process because it was "harsh and oppressive."

Justice Scalia could have used *Calder v. Bull* to legitimately strike down the retroactive taxation in *Carlton*, without succumbing to substantive due process. For example, Carlton's argument could have addressed the Constitution's explicit prohibition of ex post facto laws and included an analysis of the flawed logic of the *Calder* decision. The lawyers in *Carlton* were in the unenviable position of arguing with one hand tied behind their backs when they attempted to challenge the government's retroactive actions without referring to *Calder*.

In addition, the law in *Carlton* could have been overturned based on the argument that it violates procedural due process. The rather vague standard for substantive due process ("unduly harsh and oppressive") is unlike the standard for procedural due process, which requires that an individual have notice of laws and an opportunity to be heard. The retroactive taxation could have been struck down on the grounds of procedural due process without invoking Scalia's concerns about the oxymoronic nature of substantive due process.

### *Stephen Munzer: Is Justice a Basis for Retroactive Legislation or Is It Duplicity?*

There is one prominent author in the literature who explicitly attempts to provide a normative basis for retroactive legislation. It is to Stephen Munzer's credit that he does provide such an explicit justification, beyond the modern Court's rationale that a "legitimate legislative purpose furthered by rational means" justifies such legislation.

According to Munzer (1982), the prohibition against retroactive laws relies heavily on the justice of the existing laws which cannot be retroactively changed. For instance, Munzer notes that laws allowing all Nazi's to escape punishment for killing Jews, or slaveholders to keep their slaves forever, should not be immune from retroactive legislation (ibid.: 434). Such examples lead Munzer to conclude that there should not be a total prohibition against retroactivity. Instead, Munzer argues that there should be a presumption against retroactivity that can be overruled when existing laws are deemed unjust.

Although Munzer initially provides examples that evoke general sympathy, he goes on to espouse the more problematic view that redistributional considerations should generally permit retroactive laws. Munzer states that his general argument does not presuppose any particular conception of justice. However, he expresses sympathy for a view of justice close to the view advocated by John Rawls (ibid.:


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435–9). Rawls (1971) argues that the basic institutions of society should be organized to make the least advantaged individuals (or groups) in society as well-off as possible. He calls this the "Difference Principle." Rawls embraces an egalitarian framework in which potentially large gains of material well-being for the rest of society are held hostage to the incremental gains for those who are "worse off" in society.

Munzer argues that cases involving retroactivity should be filtered through this redistributivist prism. If the poor are favored by retroactive laws, or if the rich are disadvantaged while society benefits, then a strong case can be made for allowing a retroactive law. In *U.S. Trust Co. v. New Jersey* (1977), in which bondholder rights were retroactively weakened, Munzer supports the Court's holding that retroactivity should have been allowed. *U.S. Trust* involved a bond covenant that barred the Port Authority from investing in mass transit projects that incurred deficits beyond a certain limit. The Court reasoned that the new projects the Port Authority was barred from undertaking would have helped society in general while prosperous bondholders would have been only marginally disadvantaged. With this logic, the Court held that retroactive legislative action breaking the bond covenant was permissible. According to Munzer, a worthwhile societal aim was furthered by the weakening of bondholder rights.

Munzer's argument for retroactivity contends that Rawls's redistributivist view allows for weaker adherence to the rule of law than Hayek's view. What Munzer overlooks is the element of *publicity*. Publicity is one of the major arguments for Rawls's two principles of justice and a constraint upon any acceptable outcome from a Kantian-contractarian framework in which rational actors knowingly choose basic principles by which they live.[3] The basic laws of society must be known to the public. It is impossible to square publicity in Rawls's theory with retroactivity where, by definition, citizens will not be able to know the basic laws as they exist at the time.

Another problem with arguing for retroactivity from egalitarian redistributional principles is the existence of the progressive income tax. The basic laws of a progressive income tax already reflect the redistributional impulses of the democratic majority. As long as those tax laws are prospective, individuals know that if they work in the future, they must give a percentage of their earnings to the government for egalitarian redistribution. Retroactive redistribution *in addition* to the income tax is problematic because society has basically

[3]A contractarian framework, which Immanuel Kant employed, assumes that ethical principles are those contracted or agreed to by moral agents acting impartially.

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set a limit to the amount of redistribution it considers fair via prospective progressive income tax laws. Any further redistribution forced by retroactive laws is basically deceitful as it cannot be passed in advance by a democratic majority contemplating a chosen level of redistribution.

It is therefore somewhat self-defeating to state a coherent, specific principle allowing retroactivity. For example, if bondholder covenants could be retroactively weakened or employers could be made to retroactively increase benefits, the redistributional benefits of retroactivity would disappear as bondholders and employers would take actions to adjust their positions prospectively. Given the existence of the prospective progressive income tax to accomplish redistribution, it is problematic to sacrifice the rule of law for the minor redistributional changes resulting from the necessarily surreptitious results of retroactivity.

*Andrew Weiler: Criteria for Curtailing Retroactivity*

Some scholars have noted the unsatisfactory state of affairs with respect to retroactive legislation and have proposed criteria to make it more difficult to sustain retroactive laws. In his 1993 article "Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws," Andrew Weiler argues that the judiciary has given a rubberstamp to retroactive economic laws under the due process standard. Although Weiler does not directly challenge *Calder*, he argues that the Supreme Court has been too lax in allowing retroactivity in certain cases. He suggests that four criteria be used in analyzing retroactivity: notice, reliance, equity, and moderation of the burden. Weiler states that these factors should help reign in the excesses of retroactivity (Weiler 1993: 1126–31).

The first criteria is that of notice of the new law. Courts should find adequate notice only if the retroactivity period begins after the law's initial publication. This would include, for instance, the introduction of any bill into Congress that states that its effective date will be from its introduction rather than from its enactment.

This criteria of notice is of very little use in curtailing retroactivity because it does not enable individuals to plan their actions based on known rules. Competing and inconsistent bills are frequently introduced into Congress and an individual cannot realistically have notice as to which one will eventually be passed. Indeed, any new bill that is introduced will be in conflict with current law; thus an individual will not know whether to follow current law or one of any number of new bills.


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Unfortunately, this rather weak criteria of notice is made even less useful in Weiler's framework. He states that even if there is inadequate notice, the retroactive law need not be automatically invalidated (ibid.: 1129) Rather, it is simply one factor to be balanced against the other three factors.

The second element of reliance recognizes that a law may be less offensive if a party has no prior reasonable expectations. With respect to changes in income tax, Weiler argues that there is no reasonable reliance against changes in income tax laws; while with respect to *Carlton*, there is reasonable reliance as the government had encouraged a specific type of conduct with the favorable tax deduction. Weiler is referring to the specific encouragement the Carlton estate relied upon in selling via an employee stock ownership plan. He discusses the court of appeal opinion that found this retroactive law unconstitutional and that was later reversed by the Supreme Court.

Detrimental reliance, however, is not an adequate substitute for a prohibition on ex post facto laws. First, neither legislative enactments nor court decisions should be allowed to subvert the certainty that a prohibition on retroactivity yields. It is not acceptable to allow Congress to do an end-run around the prohibition on retroactivity by incorporating into its laws a warning that certain laws permit retroactivity. This tactic would allow a legislative enactment to override a constitutional prohibition.

The second reason that detrimental reliance is not an adequate substitute for a prohibition on ex post facto laws is that it requires and encourages ignorance of the fact that civil ex post facto laws are still permitted as a result of *Calder v. Bull*. Weiler contrasts the specific conduct encouraged in *Carlton* with the Court's strong historical acceptance of retroactive income tax laws. Weiler suggests that Carlton reasonably relied upon existing laws governing tax deductions in a way that an individual could not reasonably rely upon existing income tax laws (ibid.: 1129).

The problem with Weiler's distinction is that it is only valid if Carlton did not know that civil ex post facto laws are generally permitted. If he were more legally sophisticated and knowledgeable, he would have known that even though Congress was encouraging a specific type of conduct, it was free to change its mind retroactively for up to a two-year period. (This is true at least with respect to court decisions about income tax laws.) A theory that relies upon ignorance of the law is unsatisfactory. Short of a prohibition on all ex post facto laws, or at least certain types of civil ex post facto laws, an individual would have to be ignorant to reasonably trust that civil laws would not be applied retroactively.

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A rule that requires detrimental reliance, even after the courts have seen fit to allow retroactive civil laws generally, is illogical. Does it then make sense to require that an individual must have actually relied to his detriment on an existing civil law known to him? After all, no one knows all the civil or criminal laws at the time of action. An individual is not shielded from laws because of such ignorance. It may be more egregious if an individual actually relied on them, but reliance is hardly necessary. Thus, while actual detrimental reliance may be sufficient to outlaw retroactivity (assuming the courts would disallow it), it is hardly necessary in civil (or criminal) law.

The last two elements of Weiler's balancing test are equity and moderation of the burden. Under the equity analysis, "the rationality of the government's interest is examined and compared with the private party's conduct. This analysis provides courts with the flexibility requisite to an analysis of the inherently vague protections of the Due Process Clauses" (ibid.: 1130–1). Closely related to the equity component is the extent to which the legislature moderated the retroactive burden. The government must demonstrate the extent to which the legislature attempted to limit the severity of the changes to the prior law and the burden imposed upon the individual, and show that the length of the retroactive burden is necessary to accomplish the legislative goal. Unfortunately, the elements of equity and moderation of the burden lead us back to the due process standard that is vague in how it has been applied by the Supreme Court to retroactive laws.

Weiler is well-motivated by concern that the due process standard has resulted in the rubberstamping of retroactive laws that are objectionable. His analysis unfortunately stops short of studying the seminal *Calder* case that landed us in the predicament he laments. His patchwork solution would merely replace the vagaries of the due process standard with his obscure standards for equity and moderation of burden (as well as the other two factors mentioned).[4]

## The Impact of Ex Post Facto Laws on Property Rights

The tension between permitting civil ex post facto laws and prohibiting the taking of private property was evident in *Calder*. Indeed, we

[4]Weiler's article appears about 33 years after Charles Hochman's "The Supreme Court and the Constitutionality of Retroactive Legislation," which appeared in the *Harvard Law Review* in 1960. In his article, Hochman (1960: 697) noted, "Since the great variety of cases in this field do not lend themselves to sweeping generalizations, it seems inappropriate to attempt to develop an ideal scheme for the court to follow in cases involving retroactive statutes, nor even to offer a formula for predicting the result in any given class of cases." The need for predictability in the law is not satisfied by the loose balancing tests proffered in place of a straightforward prohibition on retroactivity.



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may well ask how there can be private property without some prohibition on ex post facto laws. One of the key marks of private property is that the property *vests* in an individual. How can property vest in an individual if the government is always free to change laws retroactively?

For instance, suppose Congress wants to change the tax law so that certain individuals owe taxes on money made three years ago. Or even more radically, suppose Congress required that all individuals who had more than $100 in the bank now have to pay 90 percent of such money in tax. Would such manifestly unjust ex post facto laws be ruled unconstitutional?

Surprisingly enough, the Court has sustained such manifestly unjust retroactive tax laws.[5] These pernicious results are traceable to *Calder*. It is particularly objectionable that the federal government be allowed to pass civil ex post facto laws when we consider that the Court's main reason for allowing civil ex post facto laws was that the contract clause and legal tender clause would have been unnecessary if civil ex post facto laws had been encompassed within the scope of the prohibition on ex post facto laws. But given that these more specific prohibitions are not stated as restrictions against the federal government (although they are against the states), an argument for allowing the federal government to pass civil ex post facto laws is extremely weak.[6]

### *Protect Property Rights by Prohibiting Ex Post Facto Laws*

Two examples are useful in illustrating how prohibitions on ex post facto laws serve to protect property rights. The first example occurs in California state law. The traditional rule in California land use law, as described in *Lippert v. Avco Community Developers, Inc.* (1976), was that there was no vested right to develop one's property until an

[5]Several Supreme Court cases have upheld retroactive taxes including *United States v. Carlton* (1994). In *Welch v. Henry* (1938), a divided Court ruled that a Wisconsin tax, which was passed in 1935 and made retroactive to 1933 income, was constitutional. More recently, in *United States v. Darusmont* (1980) and *United States v. Hemme* (1985), the Supreme Court overruled two district courts that had held that retroactive tax laws were unconstitutional. It should be noted that today's Russian Constitution explicitly prohibits retroactive tax laws.

[6]See, for example, *Untermeyer v. Anderson* (1928). The Court has sometimes declared retroactive estate and gift taxes unconstitutional on the due process grounds that there has been a voluntary action based upon reliance of no taxation. However, individuals also voluntarily work in reliance upon no (or the same) taxation and receive dividends (rather than sell assets) based upon no (or the same) taxation. Hence, this distinction seems groundless and is yet another example of how the amorphous due process standard is no substitute for the clear prohibition on ex post facto laws expressed in the Constitution.



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individual had a valid building permit and had performed substantial construction in good faith reliance upon the permit. California law was changed by the legislature in recognition of the fact that the building permit plays a relatively trivial part in the development process today, as compared to general plan amendments, zone changes, and environmental impact reports. The old law allowed a city to enact new zoning laws right up until the time that a building permit had been issued, which could be many years after a property owner applied for the subdivision permits that must be secured before a building permit could be issued. The new law, California's Government Code §66474.2, states that no new zoning laws (ex post facto laws, for example) can be applied after an individual has applied for a subdivision permit (a tentative tract map, in the parlance of California). By prohibiting the retroactive application of these zoning laws to completed applications to subdivide, the legislature expanded the rights of property owners.

The second example of the interplay between ex post facto laws and property rights occurs in *Lucas v. South Carolina Coastal Council* (1992). David Lucas paid almost one million dollars for two beachfront lots. When he bought the lots, he was allowed to build one house on each lot. The legislature then passed new laws prohibiting any building on the lots that were applied retroactively to his purchase.

The Supreme Court struck down the legislature's retroactive laws via the takings clause because Lucas was left with no viable use of his land and because he did not present any nuisance to his neighbors.[7] However, what if the new South Carolina law had allowed all owners the right to build only one house on any remaining lots they own? According to the Court, such an ex post facto law would not be counted as a taking as all use of the property has not been taken. Yet such a milder ex post facto law still would be objectionable, because it would deprive individuals of large portions and uses of their property, and it would deprive them of the ability to know in advance which laws will apply to their property.

Justice William Kennedy's concuring opinion spoke about laws that violate "investment-backed expectations" and serve as the basis for a takings claim. He stated that the Supreme Court of South Carolina erred in not making a determination that the new zoning restrictions were in accord with the owner's reasonable expectations and therefore sufficient to support a severe restriction on specific parcels of property.

[7]Technically, the Court remanded the case back to the South Carolina Supreme Court to either make a nearly impossible finding that Lucas presented a nuisance or to strike the law down.



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The problem with a theory that relies upon investment-backed "expectations" is the requirement of determining which expectations are reasonable and which are not. The obvious definition of "reasonable expectations" is that an owner has the right to reasonably expect to develop property according to the rules in effect when he purchases the property and not to have new laws retroactively applied to his purchase of the property. It is thus much more straightforward to forbid ex post facto civil laws and formulate the rule that expectations which rely upon the existing laws are those which will be protected.

*Scope: Drawing the Line on Reliance*

The unfairness of ex post facto laws in some cases will be very clear, as in *General Motors* or *Lucas*. Some cases, however, are not quite as clear. For example, where does one draw the line when many actions form a larger plan of action, and the earlier actions are completed while the later ones are not? When a new law is enacted, how far back in the chain does one look to determine ex post facto effect? For instance, *Lucas* would protect a property owner from new zoning and building laws that are different and applied retroactively to his purchase. But what about new depreciation laws that are applied retroactively to his building—even though he has not yet started on the building?[8]

As a factual matter, it seems clear that the purchase of land and construction of a building are acts in the past that are affected when new depreciation schedules are imposed and thus would be protected from new laws. Would an action such as a mere trip down to a local zoning board be protected, even before there was any other action accompanying it and creating further reliance upon the existing laws? Probably not. Will there be some intermediate cases in which it is difficult to say if the past action is part of an on-going course of action that is being affected by the new law?[9] Obviously, yes.

This issue is no different from criminal law, however, where a conspiracy to commit a crime may take place over a long period of time, with the earlier actions being committed well before the later ones. If the law has been strengthened by the time the later actions are committed, but not the earlier ones, we encounter the same issue

[8]Sadly, this possibility is more than a hypothetical example. The 1986 tax law radically changed depreciation schedules to buildings that had been purchased under the old laws.

[9]Thus, even with an explicit prohibition of ex post facto laws, in some cases there would still be the issue of Justice Kennedy's concern for reasonable expectations. Without such a prohibition, however, no reliance on past laws can be said to be reasonable. A prohibition on ex post facto laws is thus a necessary but insufficient condition for reasonable expectations against changes in the law where an ongoing course of action is involved.



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of defining the extent to which the earlier actions must be connected to the later ones for there to be an ex post facto situation. For instance, if active planning for a conspiracy took place, there is an integrated course of action. On the other hand, if only an unrelated trip to a library took place to gather information (which was coincidentally later used in the crime), there is no such integrated course of action and therefore no ex post facto situation.

In *Takings* (1985), Richard Epstein forcefully argues for a concept with respect to property that applies equally to ex post facto laws: just because there are some difficult cases does not mean that the concept should be discarded when there are so many clear cases.

The last section of this paper will propose a comprehensive solution to the problems created by ex post facto laws, but in the absence of a thorough solution, we will consider two situations in which ex post facto laws seem most objectionable. The first is when there are no further actions to be undertaken as part of a course of action. This is a pure ex post facto situation where a course of action has been completed and then the existing laws are changed. An example of this would be if the 1992 tax laws were changed so that an individual owes more money on his 1990 taxes.

This situation seems more objectionable than if the laws are changed on future taxes, even though those changes may frustrate the expectations of those who relied on the earlier law. Thus, for instance, it seems more objectionable to be told to pay an additional sum for your 1990 taxes than it is to be told that depreciation laws will change in the future years, even though an individual may have purchased property based on an expectation that there would be no such changes applied to his past actions like the purchase of the land.

The difference between the two examples is in degree, not kind. Even in the first case of the individual with an already completed course of action who is told he must pay more taxes on his 1990 returns, there is still the issue of whether he reasonably relied upon the 1990 laws not being changed when he filed. This question of reasonable reliance exists with respect to past actions just as much as the question of reasonable expectations exists with respect to future actions. In fact, barring an effective prohibition against ex post facto laws, any reliance upon existing laws is misplaced and unreasonable. Although the example of a retroactive billing on 1990 taxes may seem farfetched, it is logically equivalent to what happened in *General Motors*, where the Court told the automobile companies that they retroactively owed money on already completed actions. Applying the amorphous standard of a "legitimate legislative purpose furthered by rational means," a court could no doubt find that retroactive laws on taxes satisfy the standard as well.



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The second type of ex post facto law that is particularly objectionable is where the future actions that are affected are well-articulated. If they are well-defined, there is not a problem of whether there is any abuse of the system if an individual claims that his prior plans (extending into the future) were frustrated.

One way for the plans to be well-defined is through a contract. This is one attractive feature of the contracts clause, which *Calder* rightly recognized as containing a prohibition on a certain kind of ex post facto laws. Although the contracts clause prohibits ex post facto laws on actions that have not been completed, at least there is a contract that spells out what the future contemplated actions are. Hence, because we know what these actions are, via the contract, there is less potential for abuse (for example, abuse by someone trying to feign that they were wrongfully affected when they actually were not). A contract is not the only way to set forth the future course of action. Instead, an edict for the future can come directly from the government as can be seen by California Government Code §66474.2, California's recent move to prohibit retroactive zoning laws after an individual has applied for a subdivision permit.

A third type of ex post facto law is one that deals solely with public property—for example, laws governing speed limits on freeways, kinds of vehicles allowed on roads, and access to parks. It seems that in these areas there is less claim for enforcement of the prohibition against ex post facto laws. For instance, if the speed limit is decreased, it does not seem that car manufacturers would have a constitutional claim based upon the fact that they geared their high end production cars to a higher speed limit. The roads belong to the public and recognizing expectations that prohibit policy changes with regard to publicly owned land might obstruct needed improvements.

Although these three types of ex post facto laws are not exhaustive, they are an attempt to provide some further guidance beyond that provided by the current standard that allows retroactive legislation as long as it satisfies the standardless criteria of a "legitimate legislative purpose furthered by rational means." Courts and legislatures would do well to be more wary of ex post facto laws of the first two types and to be more liberal in the last area. As we shall see in the last section of the paper, however, a comprehensive solution to ex post facto laws will obviate the need for specific proposals.

## A Proposal: Provide Just Compensation for Unfair Retroactivity

Something more than the rather lax standard of a "legitimate legislative purpose furthered by rational means" is needed to protect due



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process rights. Weiler's proposal highlights the problem but does not suitably solve it.

One suitable proposal for handling retroactive legislation is a more flexible approach that would allow retroactive laws so long as individuals harmed by the new laws are compensated. It would make retroactive analysis similar to Fifth Amendment takings analysis. For example, a taking for the public good is permissible if there is compensation to the individuals whose property is taken. Thus, if the state wants to impose new environmental clean-up laws on property owners retroactively, it must pay just compensation to them.

Given the close connection between a prohibition on retroactive civil laws and the safeguarding of private property rights, it should not be surprising that enlightened retroactivity analysis mirrors takings analysis. The Fifth Amendment, which allows takings for public use provided compensation is paid, came after the absolute ban on retroactive laws contained in the original Constitution. Therefore, the Fifth Amendment can be viewed as implicitly amending the absolute ban on retroactivity to allow retroactivity if compensation is paid to harmed individuals.

This proposal makes it possible to respond to one of the chief arguments that proponents of retroactivity have given, namely, that retroactivity should be permitted because the state needs *flexibility* in running its affairs (*e.g., Weiler* 1993). Allowing retroactivity if compensation is paid offers the state the flexibility that the Fifth Amendment allows; the state merely needs to pay for it. This flexibility, moreover, is not invented by relying on the vagaries of "substantive due process." It flows from the initial wording of the Constitution banning ex post fact laws and an analysis of the subsequently passed Fifth Amendment that allows takings as long as individuals are compensated.

## Conclusion

F.A. Hayek was correct to point out that, if coercion cannot be eliminated, its ill effects can be curtailed by letting individuals know in advance how coercive laws will affect them. In order for people to plan for such laws, they must be known and certain. Subsequently, ex post facto civil and criminal laws must be prohibited.

Due to the Supreme Court's error-ridden analysis in *Calder v. Bull*, the prohibition against ex post facto laws has been applied only to criminal laws. As an analysis of *United States v. Carlton* and significant policy considerations indicates, this prohibition deserves to be extended to civil laws. Retroactive laws should be permitted only if just compensation is paid to harmed individuals.



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# The Effect of Race and Sex on Welfare Benefits

*Howard Gensler*

The organization of income-maintenance programs in the United States is mandated to a large extent by federal regulations, because most programs are funded by the federal government. However, the historically local nature of charity and relief in the United States has resulted in individual states and counties implementing most welfare programs.[1] The system is far from unified, with a host of relatively independent programs that differ in the nature of benefits, funding source, and control.

The U.S. welfare system is designed to relieve economic need, which depends on income and family size and varies by location and over time. Welfare is not awarded automatically, but is obtained through application and qualification that are affected by administration and organization. The issue this paper examines is whether, in practice, personal characteristics affect the allocation of welfare grants. The personal characteristics examined are race and sex.

Welfare depends on need, which is a function of family size and income. Larger families have greater need and qualify for more support. As income increases, need declines and support is curtailed. That basic relationship characterizes the nature and structure of the various welfare programs. Racial and sexual preferences have not been incorporated in the statutory criteria for the determination of welfare benefits. The American welfare system can be tested for race-based and sex-based welfare grant allocation disparities through an analysis of welfare and income data from the Current Population Survey (CPS).

There have been many studies of differentials in wages attributable to personal characteristics such as race and sex. The initial empirical

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[1]See LaFrance (1982), Drew (1987), and Peterson and Rom (1990).



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studies noted a disparity in wages between the races and the sexes. This disparity shrank the more other things were held constant. Controlling for education, tenure, noninterruption of employment history, residence, and occupational choice, the disparity in wage rates between the races and the sexes declined significantly.[2] Although the earnings gap between the races and the sexes in the workplace has been well studied, similar attention has not been paid in the public arena. There have been no previous investigations into the neutrality of welfare allocations. Barr and Hall (1975) estimate the implicit tax rate of the Aid to Families with Dependent Children (AFDC) program. They include a "dummy variable" for race in their model of benefit determination. Of the nine cities which they analyze, race is statistically significant in only three cities, and of nontrivial magnitude in just one city.

This article employs the same type of analysis that Barr and Hall undertook, only with the specific aim of estimating the impact of group-specific characteristics on welfare grant allocations. After developing a general model of welfare benefits, a test for disparity in welfare allocations is proposed. The data analyzed in the study are then described, and the results are presented. Statistically significant disparities in the allocation of welfare based on personal characteristics such as race and sex are ascertained by the test.

## A General Model of Welfare

Welfare consists of a guarantee level and an implicit tax rate at which benefits are forfeited as income is earned. Although most American welfare funding is federal, the benefit levels are set by the states and vary widely. As Moffitt (1992) notes, the AFDC benefit for a family of four in 1989 ranged from $144 per month in Mississippi up to $788 per month in California. Although the AFDC tax rate is mandated by Congress, the variation in implicit tax rates among the states is well documented.[3] Accordingly, welfare must be estimated at the state level. The general model for welfare is as follows:

$$W = \alpha + \beta K + \tau Y, \tag{1}$$

where W is the amount of welfare per year, K is the number of children, and Y is family income.[4] Here, $\alpha$ is interpreted as the guarantee amount

[2]See Blau and Ferber (1987), Blinder (1973), Cain (1986), Corcoran and Duncan (1979), Field and Wolff (1991), Flanagan (1974), Groshen (1991), Gwartney and Stroup (1973), Mincer and Polacheck (1974), Oaxaca (1973), and Roos (1981).

[3]See Lurie (1974) and Fraker, Moffitt, and Wolf (1985).

[4]See Appendix for specifications of the full model by family structure.



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for the adult(s), $\beta$ is the additional amount of welfare allowed per child, and $\tau$ is the tax rate on income.[5]

## The Disparity Test

The magnitude of disparity in allocations of welfare due to race or sex can be ascertained by the inclusion of a dummy variable for the personal characteristic of interest in welfare-benefits model. Interactive terms between the personal characteristic dummy variable and the children variable determines the difference in welfare allocation per child by group. Interactive terms between the personal characteristic dummy variable and the income variables identifies differences in implicit tax rates between the groups. Differences in funding levels across time can be controlled for by including a vector of year dummy variables. Because welfare is administered at the state level, the model is estimated separately for each state. The basic test can be illustrated as follows:

$$W = \alpha + \gamma_p P + \beta K + \gamma_k PK + \tau_y Y + \gamma_y PY, \tag{2}$$

where P is the dummy variable for the personal characteristic. The coefficient on the personal characteristic dummy variable, $\gamma_p$, is the magnitude of disparity in base welfare allocations due to the personal characteristic. The coefficient on the children variable interacted with the personal characteristic dummy variable, $\gamma_k$, indicates the magnitude of the disparity in welfare allocations per child due to the personal characteristic. The coefficients on the income variable interacted with the personal characteristic dummy variable, $\gamma_y$, indicates the difference in the implicit tax treatment of income between the two groups.[6]

## The Data

The data used in this study come from the U.S. Department of Commerce, Bureau of the Census' *Current Population Surveys: Annual Demographic Files* (1980–91).[7] The data set includes labor

[5]Because of the problem of left-censoring at the zero welfare benefit level, estimating welfare program parameters with ordinary least squares regression applied to a sample restricted to welfare recipients will provide biased estimates. The correct estimation technique is the Tobit procedure applied to a sample of welfare recipients and nonrecipients. See Maddala (1988); Amemiya (1973); and Fraker, Moffitt, and Wolf (1985).

[6]See Appendix for specifications of the full disparity test by family structure.

[7]The original collector of the data, the U.S. Bureau of the Census, and the distributor of the data, the Inter-University Consortium for Political and Social Research, bear no responsibility for uses of the data nor for interpretations or inferences based on such uses. All opinions, analyses, and conclusions are solely the author's.



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force data, demographic information, and other economic information on persons older than 14. The population is limited to civilian residents of the United States living in noninstitutional circumstances and men in the Armed Forces residing in nonmilitary housing. Nearly 60,000 households across almost 2,000 counties are contacted each year.

For my study, I used a sample of low income, nonmilitary, nonfarm households derived from the March CPS files. Total household income was limited to twice the official poverty level. Because my study analyzes welfare, individuals with higher incomes were not included. The following comparisons were made: (1) Black and non-black households consisting of single females with children and also married couples with children were compared to determine whether there was a race-based disparity in welfare allocations; and (2) single females with no children were compared to single males with no children to determine whether there was sex-based disparity in welfare allocations. Although it would have been more interesting to compare single females with children to single males with children because welfare largely depends on the presence of children, there are so few single males with children in the sample that such a comparison could not be made. Subjects were further limited in age from 18 to 65. Alaska, Hawaii, and Puerto Rico were excluded, and the District of Columbia was included. CPS data are cross-sectional data collected annually. Economic data are from the previous year. Therefore, information for the years 1979 through 1990 was collected. The 12 annual independent data sets were pooled. All dollar figures are expressed in constant 1986–87 dollars.

For the study of single females with children, 20,281 pooled observations were analyzed. The average age of the single female was 31.5, with an average of 11.1 years of education. Thirty-three percent of the single females were black and 56 percent received some amount of welfare. Earned income averaged $3,616 per year. Unearned, nonwelfare income averaged $2,200 per year. Finally, 59 percent participated in the labor force. Those women received an average of $2,135 in welfare payments per year. Given that a single female household head received welfare, the average annual grant was $3,810.

For the study of married couples with children, 25,442 pooled observations were analyzed. The average age of husbands was 34, with an average of 11 years of education. The average age of wives was 32.1 years, with an average of 11 years of education. Eleven percent of the sample was black and 26 percent received some amount of welfare. Husbands earned an average of $9,935 per year; wives earned an average of $2,020 per year. Families had an average of $1,380 of unearned, nonwelfare income per year. Eighty-five percent



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of husbands and 52 percent of wives participated in the labor force. Those families received an average of $601 of welfare per year. If the family actually received welfare, the average annual grant was $2,345.

The sample of 22,292 single persons with no children consisted of 12,567 single females and 9,725 single males. The average age of the single female was 41, with an average of 11.6 years of education. Of the women, 14 percent were black, 64 percent participated in the labor force, and 20 percent received some amount of welfare. Wage income averaged $3,248 per year, and nonwage, nonwelfare income averaged $1,911 per year. The group received an average welfare payment of $202 per year. Given that the subject was a welfare recipient, the average welfare payment per year was $1,024.

The average age of the single male was 34.9, with an average of 11.8 years of education. Of the men, 16 percent were black, 73 percent participated in the labor force, and 16 percent received some amount of welfare. Wages averaged $3,248 per year, and annual nonwage, nonwelfare income averaged $1,911. That group received an average welfare payment of $178 per year. Given that the subject was a welfare recipient, the average welfare payment per year was $1,080.

Welfare included the cash or cash-equivalent income support programs. Those programs include AFDC, food stamps, the low income home energy assistance program, emergency assistance, and general assistance. AFDC requires the presence in the home of a dependent child. In 1990, $21 billion was allocated through that program to 12 million people. Food stamps provided $18 billion in benefits in 1990, and energy assistance provided nearly $1.4 billion in subsidies that year. Emergency assistance, a federal program designed to prevent the termination of vital utility service caused by unforseen personal problems, provided nearly $350 million in assistance in 1990. General assistance, a county-based relief program, is the historical origin of welfare. Despite the rise of the federal dollar on the welfare scene, general assistance provided $2.9 billion in 1990. It is clear that a study of welfare cannot be limited to AFDC, which accounts for only about 50 percent of the income-maintenance programs in the United States.[8]

## Results of the Disparity Tests

The data sets were analyzed separately for race and sex disparity as appropriate in welfare allocations at the national and state levels.

[8]Housing subsidies were excluded from this measure of welfare. Although housing subsidies are a cash-equivalent welfare program, they are difficult to value. Less than 7 percent of single female-household heads and less than 2 percent of the married couples with children received any amount of housing assistance, so the magnitude of the understatement should be small.

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In the national test for single female household heads, blacks received $756 more per year than non-blacks. There was no statistically significant difference in welfare allocations per child between races. However, blacks paid 7 percent more tax on earned income and 14 percent more tax on unearned income. The results of the national-level test for single female household heads are presented in Table 1.

The results for the individual state-level tests for single female household heads are presented in Table 2. For single female household heads, 13 states had statistically significant base welfare allocation disparities attributable to race. Eleven states favored blacks, and two states favored non-blacks. Of the 11 states that favored blacks, only two gave a statistically significant smaller amount of money to black children than to non-black children (six more states gave less money to black children, but not at the statistically significant level of 95 percent). Both states that gave non-blacks more welfare gave a statistically significant smaller amount of money to non-black children. Another three states gave a statistically significant greater allocation to black children, and two more states gave a statistically significant greater allocation to non-black children. Assuming a two-child family with no income, the total disparity from the guaranteed level of benefits and the child allotment was computed for states where one or the other of the two factors was statistically significant. The results are presented in the final column of Table 2. Fifteen such states gave

*TABLE 1*

NATIONAL-LEVEL RACE-BASED DISPARITY: SINGLE FEMALE HOUSEHOLD HEADS

| Variable | Coefficient | Std. Error | *t* |
|---|---|---|---|
| Race dummy | 755.54 | 110.31 | 6.85 |
| Children | 1,247.86 | 27.82 | 44.85 |
| Earned income | −.591 | .009 | −68.79 |
| Unearned income | −.378 | .009 | −42.42 |
| Race dummy × children | −17.67 | 40.69 | −0.43 |
| Race dummy × EI | −.067 | .013 | −5.05 |
| Race dummy × UI | −.137 | .014 | −9.92 |
| Year dummies | Yes | | |
| State dummies | Yes | | |
| Constant | 2,633.06 | 108.77 | 24.21 |

NOTES: Tobit estimation of welfare model for single female household heads. Dependent variable is welfare per year; observations are 20,281; log likelihood is −111,950; race dummy is black = 1, otherwise = 0; EI is earned income per year; UI is unearned income per year. All dollar values are in constant 1986–87 dollars.



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*TABLE 2*

STATE-LEVEL RACE-BASED DISPARITY: SINGLE FEMALE HOUSEHOLD HEAD

| State | G | C | $T_y$ | $T_v$ | Net |
|---|---|---|---|---|---|
| AL | $570 | $218 | .02 | .16 | |
| AR | 1,288* | 28 | −.02 | .03 | $1,344 |
| AZ | −2,309 | 773 | .40 | .17 | |
| CA | 1,866* | −321 | .05 | .05 | $1,224 |
| CO | 2,803 | −3,234* | .20 | .77* | −$3,665 |
| CT | −1,737 | 763 | −.01 | −.01 | |
| DE | 729 | −741 | .23 | .52* | |
| FL | 1,481* | 80 | .00 | −.04 | $1,641 |
| GA | 977 | 282 | −.02 | −.01 | |
| IA | −2,286* | 1,590* | −.14 | .38* | $894 |
| IL | 35 | 391* | −.02 | .15* | $817 |
| IN | 1,259 | 205 | −.06 | −.07 | |
| KS | 2,484* | −300 | .09 | −.26* | $1,884 |
| KY | −418 | 313 | .03 | −.14 | |
| LA | 2,817* | −203 | −.01 | .29* | $2,411 |
| MA | −207 | −251 | .15 | .22 | |
| MD | 1,715 | 468 | −.19* | −.12 | |
| MI | 1,589* | −509* | .00 | .27* | $571 |
| MN | −190 | 693 | −.19 | −.14 | |
| MO | 691 | 196 | .16* | .26* | |
| MS | 2,136* | −358 | −.08 | .13 | $1,420 |
| NC | 957 | 347 | −.04 | .06 | |
| NE | 1,011 | 20 | −.02 | .33 | |
| NJ | 1,431* | −355 | .02 | .26* | $721 |
| NM | −2,280 | 820 | −.15 | .23 | |
| NY | 178 | −334* | .19* | .06 | −$490 |
| OH | 591 | 235 | .01 | .03 | |
| OK | 252 | 548 | −.12 | −.09 | |
| OR | 2,079 | −107 | .01 | −3.41 | |
| PA | 592 | −67 | .20* | −.03 | |
| RI | 2,724* | −1,255* | .17 | .48* | $214 |
| SC | 977 | 760* | −.06 | −.07 | $2,497 |
| TN | 1,490* | 262 | .00 | −.08 | $2,014 |
| TX | 587 | 116 | −.01 | .00 | |
| UT | 344 | −245 | .20* | .11 | |
| VA | −72 | 1,151* | −.01 | .08 | $2,950 |
| WA | 2,678 | −668 | .04 | −.41 | |
| WI | −2,077* | 860* | .06 | .61* | −$357 |
| WV | 3,990* | −531 | −2.05* | −.22 | $2,928 |

NOTES: Tobit estimation of welfare model for single female household heads. G is the extra amount of welfare blacks receive; C is the extra welfare per child blacks receive; $T_y$ and $T_v$ are the additional taxes blacks pay on earned and unearned income, respectively. *Significant at the 95% level.

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black families an average of $1,569 more welfare per year than non-black families. Those states were Virginia ($2,950), West Virginia ($2,928), South Carolina ($2,497), Louisiana ($2,411), Tennessee ($2,014), Kansas ($1,884), Florida ($1,641), Mississippi ($1,420), Arkansas ($1,344), California ($1,224), Iowa ($894), Illinois ($817), New Jersey ($721), Michigan ($571), and Rhode Island ($214). Three states gave non-black families an average of $1,504 more welfare per year than similarly situated black families. Those states were Colorado ($3,665), New York ($490), and Wisconsin ($357).

For married couples with children, the national analysis indicated that blacks receive $395 more welfare per year, but $27 less welfare per year per child. Black fathers paid 14 percent less in implicit taxes than their non-black counterparts, and black mothers paid 4 percent less in taxes. Blacks paid 4 percent less taxes on unearned income. Assuming a two-child family with no income, blacks would have received $341 more welfare per year than non-blacks. The results of the national-level analysis are presented in Table 3.

The results for the individual state-level tests for married couples with children are presented in Table 4. Six states awarded a statistically significant greater base amount of welfare to blacks, and two states awarded non-blacks a greater base amount. One additional state awarded more welfare for each child to blacks, and four states (including

*TABLE 3*

NATIONAL-LEVEL RACE-BASED DISPARITY: MARRIED COUPLES WITH CHILDREN

| Variable | Coefficient | Std. Error | *t* |
|---|---|---|---|
| Race dummy | 395.19 | 210.63 | 1.89 |
| Children | 153.27 | 6.39 | 24.00 |
| Husband's income | −.408 | .007 | −62.51 |
| Wife's income | −.413 | .013 | −32.64 |
| Unearned income | −.231 | .012 | −19.15 |
| Race dummy × children | −27.31 | 9.07 | −3.01 |
| Race dummy × HI | .139 | .015 | 9.24 |
| Race dummy × WI | .041 | .029 | 1.45 |
| Race dummy × UI | .144 | .029 | 3.76 |
| Year dummies | Yes | | |
| State dummies | Yes | | |
| Constant | 2,530.79 | 159.00 | 15.92 |

NOTES: Tobit estimation of welfare model for married couples with children. Dependent variable is welfare per year; observations are 24,340; log likelihood is −67,036; race dummy is black = 1, otherwise = 0; HI is husband's annual income; WI is wife's annual income; UI is unearned income per year. All dollar values are in constant 1986–87 dollars.



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*TABLE 4*

STATE-LEVEL RACE-BASED DISPARITY: MARRIED COUPLES WITH CHILDREN

| State | G | C | $T_w$ | $T_h$ | $T_v$ | Net |
|---|---|---|---|---|---|---|
| AL | $256 | $68 | .04 | .06 | .25* | |
| AR | 2,872* | −58 | −.11 | −.11 | −.06 | $2,756 |
| AZ | 7,495* | −187 | −.20 | −.24 | −1.37* | $7,121 |
| CA | 1,956 | −10 | −.11 | .05 | .05 | |
| DE | 1,829 | 58 | −.09 | −.03 | −.19 | |
| FL | 781 | −13 | −.02 | .11* | −.04 | |
| GA | 189 | −57 | −.07 | .17* | .23 | |
| IL | 4,804* | −17 | −.26* | −.29* | −.46* | $4,770 |
| IN | −1,260 | −30 | .24* | .20* | −.01 | |
| KS | 1,594 | 1,224 | — | −.08 | .23 | |
| KY | −3,865* | 64 | .45* | .37* | −.10 | −$3,737 |
| LA | 3,373* | −6 | −.31 | .03 | −.35* | $3,361 |
| MA | −2,081 | −267 | −.20 | .39 | −.53 | |
| MD | −2,577 | −0 | .17 | .27 | — | |
| MI | 1,424 | −28 | −.21 | .01 | .11 | |
| MO | 1,497 | 194* | −.22 | −.06 | .09 | $1,885 |
| MS | 2,551* | −49* | −.12 | .00 | −.08 | $2,453 |
| NC | 477 | 27 | −.14* | .13 | .03 | |
| NJ | −1,082 | 35 | .24 | .37* | .15 | |
| NV | 5,311 | −1,875 | .23 | −.18 | — | |
| NY | −1,083 | −19 | .08 | .19* | .24 | |
| OH | −798 | −155* | .27* | .18* | .30* | −$1,108 |
| PA | 1,971 | −12 | .23 | −.07 | −.04 | |
| SC | 1,278* | −57* | −.24* | .13* | .03 | $1,164 |
| TN | −1,379* | −35 | .05 | .13* | .66* | −$1,449 |
| TX | −479 | −73* | .16* | .05 | .14 | −$625 |
| VA | 717 | 133 | −.19 | .02 | −.11 | |
| WI | −6,963 | −83 | −.35 | −.53 | .01 | |
| WV | −$2,000 | $9 | .43* | .10 | .14 | |

NOTES: Tobit estimation of welfare model for married couples with children; G is the extra amount of welfare blacks receive; C is the extra welfare per child blacks receive; $T_w$, $T_h$, and $T_v$ are the additional taxes blacks pay on the husband's earnings, the wife's earnings, and unearned income, respectively. Net is the additional amount of welfare that a black family with two children receives over a similarly situated non-black family where either G or C was statistically significant. *Indicates significant at the 95% level.

two additional states) gave more welfare to non-blacks for children. Assuming a two-child family with no income, the total disparity from the guarantee level and the child allotment is computed for those states where one or the other of the two factors is statistically significant. That

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calculation is presented in the final column of Table 4. Seven states awarded black families an average of $3,359 more welfare per year than similarly situated non-black families. Those states were Arizona ($7,121), Illinois ($4,770), Louisiana ($3,361), Arkansas ($2,756), Mississippi ($2,453), Missouri ($1,885), and South Carolina ($1,164). Four states awarded non-black families an average of $1,730 more welfare per year than similarly situated black families. Those states were Kentucky ($3,737), Tennessee ($1,449), Ohio ($1,108), and Texas ($625).

The national test for disparity across sex had 22,292 observations pooled over the entire 12-year period. Females received $358 per year more than males. Women received more support, but also paid higher taxes. Men lost benefits at a 32 percent rate for earned income and a 20 percent rate for unearned income. Women lost benefits at a 42 percent rate for earned income and a 25 percent rate for unearned income. (See Table 5 for those results.)

The results of the analysis at the state level for sex-based welfare allocation disparity found that 11 states had statistically significant annual welfare allocation disparities between the sexes during the period 1979–1990 at the 95 percent confidence level. Ten states, including the District of Columbia, favored women. They were New Hampshire ($2,606), Iowa ($1,337), Washington, D.C. ($1,330), Massachusetts ($1,309), New Jersey ($1,138), South Carolina ($1,091), New Mexico ($912), Mississippi ($895), Illinois ($810), and Texas ($444). Only one state, Montana ($674), favored men. The ten states

*TABLE 5*

NATIONAL-LEVEL SEX-BASED DISPARITY

| Variable | Coefficient | Std. Error | *t* |
|---|---|---|---|
| Sex dummy | 358.25 | 66.97 | 5.35 |
| Wage income | −.318 | .011 | −28.83 |
| Unearned income | −.201 | .013 | −15.41 |
| Sex dummy × WI | −.100 | .015 | −6.63 |
| Sex dummy × NI | −.048 | .017 | −2.78 |
| Year dummies | Yes | | |
| State dummies | Yes | | |
| Constant | −542.95 | 144.00 | −3.75 |

NOTES: Tobit estimation of welfare model for single men and women. Dependent variable is welfare per year; observations are 22,292; log likelihood is −41,630; sex dummy is female = 1, male = 0; WI is wage income; NI is nonwage income. The positive amount for the sex dummy variable coefficient indicates the additional amount of welfare women receive over similarly situated men. Negative amounts for the coefficient on the sex dummy variable interacted with the income variables indicate the higher level of implicit taxes women pay.



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*TABLE 6*

STATE-LEVEL SEX-BASED DISPARITY

| State | G | $T_y$ | $T_v$ | State | G | $T_y$ | $T_v$ |
|---|---|---|---|---|---|---|---|
| AL | $647 | −.12 | −.10 | AR | $416 | .07 | .00 |
| AZ | 921 | −.05 | 1.59 | CA | −286 | −.03 | −.01 |
| CO | 753 | −.11 | −.13 | CT | −1,455 | −1.18 | −.17 |
| DC | 1,330* | −.23 | −.10 | DE | 1,482 | −.30* | −.20 |
| FL | 607 | −.16* | .01 | GA | 245 | .00 | .05 |
| IA | 1,337* | −.32* | −.10 | ID | 348 | .03 | −.05 |
| IL | 810* | −.12 | .02 | IN | −51 | .08 | .01 |
| KS | 557 | −.45 | −.14 | KY | 423 | .09 | −.03 |
| LA | −518 | −.07 | .04 | MA | 1,309* | −.04 | −.29* |
| MD | 936 | .02 | −.34 | ME | −297 | −.03 | .05 |
| MI | −426 | −.10 | .08 | MN | 212 | −.32* | .11 |
| MO | 260 | −.10 | .05 | MS | 895* | −.10 | −.05 |
| MT | 674* | .06 | −.19* | NC | 401 | −.11* | −.07 |
| ND | 502 | −.13 | .05 | NE | −758 | −.20 | .31 |
| NH | 2,606* | −1.86 | −.43 | NJ | 1,138* | −.23* | −.23 |
| NM | 912* | −.11 | −.12 | NV | 1,128 | −.07 | −.20 |
| NY | 410 | −.10 | −.09 | OH | 171 | −.12 | −.06 |
| OK | 641 | −.06 | −.09 | OR | −376 | .03 | .10 |
| PA | 7 | −.04 | .00 | RI | 606 | .05 | −.07 |
| SC | 1,091* | −.11 | −.27 | SD | −641 | .05 | .25* |
| TN | −409 | −.03 | .04 | TX | 444* | −.05 | −.04 |
| UT | 651 | −.24 | −.29 | VA | −671 | −.10 | .14 |
| VT | −56 | .07 | .07 | WA | 1,060 | −.05 | .05 |
| WI | 734 | −.29 | −.15 | WV | −625 | −.08 | .03 |
| WY | 51 | .02 | .10 | | | | |

NOTES: Tobit estimation of welfare disparities between single men and women. G is the amount of additional welfare guarantee level afforded women; $T_y$ is the additional tax rate on earned income paid by women; $T_v$ is the additional tax rate on unearned income paid by women. *Indicates significant at the 95% level.

that favored women gave them an average of $1,187 more welfare per year. The results of the individual state-level tests are presented in Table 6.

## Conclusion

At the national level, both the race-based and sex-based analyses for every group examined found that disparities exist in the allocation of welfare. Black single female-headed households received $756 more welfare per year than similarly situated non-black families. For a one-child family, this difference amounted to 16 percent. For a two-child

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family, this difference amounted to 13 percent. Black two-parent families received $395 more base welfare per year, but $27 less welfare per year per child, than similarly situated non-black families. That difference amounted to 12 percent for a one-child family and 11 percent for a two-child family. Similarly, significant sex-based disparities existed in the allocation of welfare at the national level. Single women with no children received $358 more welfare per year than similarly situated men.

At the state level for single female-headed households, 15 states gave blacks an average of $1,569 more welfare per year, and three states gave non-blacks an average of $1,504 more welfare per year. At the state level for married couples with children, seven states gave blacks an average of $3,359 more welfare per year, and four states gave non-blacks an average of $1,730 more welfare per year. With respect to sex-based disparities, ten states gave women $1,187 more welfare per year on average, and one state gave men $674 more welfare per year.

The analysis of disparity in the allocation of welfare based on personal characteristics such as race and sex indicates that fundamental problems of equity in either access or assessment persist in the income maintenance system. Although it is not clear why certain groups benefit disproportionately in the welfare system, it is certainly arguable that the method of welfare allocation is a root cause. An alternative system such as a negative income tax program, based solely on income, would be free from possible biases in access, administration, design, targeting, or availability. A federal negative income tax system would also allow uniformity in support levels and implicit tax rates.

The cost of living varies more within states than across states. McMahon and Melton (1978) note that interstate costs of living vary 37 percent, and intrastate costs of living at the average of the county level varies from 21 percent to 37 percent in the four states they examined. Of course, as they admit, "There is heterogeneity within these areas." The intracounty cost of living variation is quite large and must be added to the reported intrastate variation, which is already comparable in magnitude to the total interstate variation. Accordingly, the argument for interstate variation in benefit levels is greatly eviscerated, and the need for local control no longer seems compelling.

However, the purpose of this discussion is not to advocate any particular solution to the problem of disparity (and variability) in welfare allocations. Rather, the purpose is to identify the nature and scope of the inequitable allocation problem itself. The reference to a negative income tax system places the problem in a context that demonstrates that a specific choice of program design may lend itself


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to greater or lesser unintended consequences. As things now stand, substantial allocation disparities persist in the administration of the American income-maintenance system.

## Appendix: Welfare Benefit Models and Disparity Tests

### *Welfare Benefit Models*

The following models of welfare reflect the different household structures.

For single female household heads:

$$W_i = \alpha + \beta_k K_i + \tau_y Y_i + \tau_v V_i + \epsilon_i. \tag{3}$$

For married couples with children:

$$W_i = \alpha + \beta_k K_i + \tau_h Y_{hi} + \tau_w Y_{wi} + \tau_v V_i + \epsilon_i. \tag{4}$$

For single persons with no children:

$$W_i = \alpha + \tau_y Y_i + \tau_v V_i + \epsilon_i, \tag{5}$$

where $W_i$ is the amount of welfare per year, $K_i$ is the number of children, $Y_i$ is the earned income of a single female household head or single person, $Y_{hi}$ is the earned income of husband, $Y_{wi}$ is the earned income of wife, $V_i$ is the unearned income excluding welfare, and $\epsilon_i$ is a mean-zero random error term of the $i^{th}$ family.

In the models given here, $\alpha$ is interpreted as the guarantee amount for the adult (or for both adults), $\beta_k$ is the additional amount of welfare allowed per child, $\tau_h$ is the tax rate on the husband's earnings, $\tau_w$ is the tax rate on the wife's earnings, $\tau_y$ is the tax rate on earned income for a single female household head or a single person, and $\tau_v$ is the tax rate on unearned income.

### *Disparity Tests*

The following models test for race disparities in various household structures:

For single female household heads:

$$W = \alpha + \gamma_r R_i + \beta_k K_i + \gamma_k R_i K_i + \tau_y Y_i + \gamma_y R_i Y_i + \tau_v V_i + \gamma_v R_i V_i + \beta_a A_i + \epsilon_i. \tag{6}$$

For married couples with children:

$$W_i = \alpha + \gamma_r R_i + \beta_k K_i + \gamma_k R_i K_i + \tau_h Y_{hi} + \gamma_h R_i Y_{hi} + \tau_w Y_i + \gamma_w R_i Y_{wi} + \tau_v V_i + \gamma_v R_i V_i + \beta_a A_i + \epsilon_i, \tag{7}$$

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where $R_i$ is a race dummy variable (black = 1, non-black = 0), and $A_i$ is a vector of year dummy variables.

The coefficient on the race dummy variable, $\gamma_r$, is the magnitude of disparity in base welfare allocations attributable to race. The coefficient on the children variable interacted with the race dummy variable, $\gamma_k$, indicates the magnitude of the race-based disparity in welfare allocations per child. The coefficients on the income variables interacted with the disparity dummy variables, $\gamma_y$, $\gamma_h$, $\gamma_w$, and $\gamma_v$, indicate the difference in the implicit tax treatment of income between the two races. To analyze racial disparity in welfare allocations at the national level, a vector of state dummy variables is added to the model. The interpretation of the coefficients is the same, but applied to the nation as a whole.

The magnitude of disparity in allocations of welfare by sex can be ascertained by the inclusion of a sex dummy variable, $S_i$ (1 = female, 0 = male), in the model of welfare benefits as developed here. Interactive terms between the sex dummy variable and the income variables identifies differences in implicit tax rates between the sexes. Disparities in the allocation of welfare by sex at the state level can be identified by estimating the expanded welfare model on each state separately. That is done for the single men and women (with no children) group:

$$(8) \qquad W_i = \alpha + \gamma_s S_i + \tau_y Y_i + \gamma_y S_i Y_i + \tau_v V_i + \gamma_v S_i V_i + \beta_a A_i + \epsilon_i.$$

The coefficient on the sex dummy variable, $\gamma_s$, is the magnitude of disparity in welfare allocations attributable to sex. As before, the coefficients on the income variables interacted with the sex dummy variables, $\gamma_y$ and $\gamma_v$, indicate the difference in the implicit tax treatment of income between the sexes. To analyze sex disparity in welfare allocations at the national level, a vector of state dummy variables is again added to the model. The interpretation of the coefficients is the same, but summarizes the nation as a whole.

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# Regional and Multilateral Trade Agreements: Complementary Means to Open Markets

*Edward L. Hudgins*

Free trade advocates face more than just the constant challenge of reminding the public and policymakers of the virtues of open global markets. They also confront theoretical and practical questions over how to secure them. In recent years the discussion has been over the respective merits of bilateral or regional free trade agreements such as the North American Free Trade Agreement (NAFTA) and the European Union (EU) on the one hand and the multilateral General Agreement on Tariffs and Trade (GATT), now manifest in the World Trade Organization (WTO), on the other.

With the establishment of GATT after World War II, the multilateral approach was the preferred method of trade liberalization. But the establishment of NAFTA has caused concerns about the rise of exclusionary trade blocks. In reaction, supporters of the multilateral approach have been reasserting their position. Yet unilateral, bilateral, regional, and multilateral trade liberalization are all valid means to open world markets. Each has its place, and no arrangement promising freer trade should be rejected without good cause.

## Regional or Worldwide Trade?

Sidney Weintraub (1996), a supporter of the multilateral approach, proceeds from the following assumptions:

- Overall wealth for both individuals and countries tends to grow when barriers to trade are removed.

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- In general, a multilateral approach to trade liberalization is best.
- Bilateral and regional agreements are justified if they create more trade than they divert.
- Regional trade arrangements should not be adopted if they maintain high trade barriers to nonmembers.

From these premises Weintraub concludes that free trade areas or regional arrangements are justified under certain conditions:

- They should not merely be exchanges of trade preferences, with countries simply removing their tariffs and other traditional barriers such as quotas. They should go beyond what can be done on a multilateral basis in the WTO.
- Regional arrangements should "deepen" trade—that is, address entrenched internal barriers to trade.
- Regional arrangements should be "open"—that is, they should allow other countries in the region to join.
- Both regional and multilateral arrangements should continue to progress, lest they atrophy.

## Four Evaluative Factors

It is useful to evaluate these proposed trade agreements in light of four factors: individual liberty, trade effects, the regulatory regime, and the political climate.

### *Individual Liberty*

Trade liberalization is, first and foremost, the removal of restrictions on the freedom of a country's citizens to dispose of their property as they see fit and to engage in voluntary exchanges with others. Thus, market liberals should establish freer trade whenever possible. It is important to put free trade in this context, for the very language used to discuss this issue is misleading. Some speak of countries making trade concessions in negotiations with other countries. But in reality it is not a "concession" if the United States government restores to its citizens some of their freedom to purchase shirts from producers in Mexico or China.

From this perspective, a country should remove its trade barriers unilaterally, whether other countries do so or not. But since no other industrialized countries yet have approached the wisdom of the policies practiced by Hong Kong, the least countries could do is never miss an opportunity to expand trade on a bilateral basis. If one's standard for judging the merits of a trade policy is whether it increases or decreases the liberty of a country's citizens, then questions of trade creation or diversion would be secondary.



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Thus, I offer the following criterion for judging the merits of a proposed regional or bilateral trade arrangement: *Does the trade arrangement increase economic freedom?* That criterion suggests that the burden of proof rests on those who would advise that an offer from another country to establish freer exchange should be turned down. There is no fundamental difference in the case for free exchange between individuals who live in different houses, on different streets, in different towns, in different states of the same country, or in different countries. Market liberals assume that such freedom should be the natural condition, with no special case or justification needed. Thus, the question we must ask is whether there are compelling reasons *not* to liberalize trade on a bilateral or regional basis if the opportunity presents itself.

### *Trade Effects*

Even critics usually concede that, in general, freer trade, including bilateral and regional liberalization, improves the welfare of all countries by promoting wealth creation. But they also maintain that under certain circumstances, opening markets with only one or several trading partners could merely divert trade. Weintraub points out, for example, that in MERCOSUR, Paraguay and Uruguay could be forced to purchase higher-priced goods from Brazil rather than from less costly suppliers.

But let us consider the various types of bilateral and regional trade arrangements in light of the economic freedom rule. To judge the effects of trade arrangements other than the multilateral GATT/WTO approach, it is necessary then to distinguish between two types of regional arrangements: free trade areas (FTAs), such as NAFTA, and customs unions, such as the EU, which maintain common barriers to nonmember countries. The greatest danger for trade distortions and compromises of economic liberty seems to lie in the latter.

*Customs Unions.* Consider an example. The Czech Republic wishes to enter the EU. That might mean simply that it removes tariffs and traditional trade barriers to EU member countries while keeping intact barriers to nonmembers (e.g., to former Warsaw Pact countries). In such a case there is no net loss of freedom for the Czech people. Rather, there is a gain.

But such an arrangement could cause some trade distortions. For example, perhaps the Czechs maintain a 5 percent tariff on imported widgets. And under this tariff, Hungarian widgets are more competitive in the Czech Republic against rival German products. Thus, the Czechs purchase most of their widgets from Hungary. But with no tariff on German widgets, the Germans,



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although less competitive head-to-head with Hungarian suppliers, might dominate the Czech market.

That situation is not a problem for the Czechs, nor a reason to remain outside of the EU. The situation would be a windfall for the Germans. They would have no reason to block Czech membership. The competitive status of widget-makers in other EU countries would remain unchanged. Only Hungary would be at a disadvantage.

If Hungary has the option to enter the EU, it could eliminate this disadvantage. But Germany might block Hungarian membership to protect its advantage in widgets. So the Czechs, who do not sacrifice freedom with initial EU membership, might be cutting off opportunities for even freer trade in the future. And so might other EU countries that would like, in the future, to purchase less costly Hungarian widgets rather than expensive German ones.

But there is more to economies than widgets. No doubt some German manufacturers would wish to acquire access to Hungary as a means to overcome their competitive disadvantage in that market against Japanese high-tech products. Then the struggle would be between German interest groups for the support of the German government. The outcome might or might not be trade maximizing.

Thus, when a country enters a customs union, it does risk gaining a short-term increase in freedom while hampering opportunities for future gains. Yet that alone does not seem a sufficient reason for not entering a regional or bilateral trade arrangement. The battle for further trade liberalization among the members of a free trade area, as well as the trade battle within each country, is always a political one. In general, free-market advocates win one battle and then go on to the next one, understanding that they will always meet resistance. Unless the prospects of future trade problems within a regional trade area are very clear, freedom is worth the risk.

*Deepening-of-Trade Problems.* But EU membership would not simply mean that the Czechs would eliminate their tariffs and other traditional trade barriers. The Czechs might find that EU subsidies, agriculture policies, or new regulations from Brussels have the effect of raising trade barriers to its old, non-EU trading partners. After all, some of the so-called deepening of trade within the EU is, in fact, bad economic policy. That situation could have the effect of limiting economic liberty for Czechs in certain sectors. In such a case the Czechs would be sacrificing certain freedoms in hopes of gaining net freedom. But the problem here is not with regional *trade* liberalization. It is with customs unions that have bad internal economic policies.



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*Safer Free Trade Areas.* In a NAFTA-type arrangement, the problem of sacrificing freedom might be reduced. Each member country retains it own trade barriers to nonmember countries. Thus, Mexicans and Canadians can continue to purchase Cuban cigars even though the United States bans the import of these products.

If Canadians decide to throw their market open completely to apparel imports from every country, they could do so. American consumers would envy their neighbors to the north. American apparel manufacturers, who hold those consumers hostage with the U.S. government as the armed enforcer, would curse the cold that woke up the Canadians to the advantages of open markets. Even Mexicans might grumble at competition in the Canadian market from Asian suppliers.

And there certainly would be more border activity as American customs officials block shipments of non-NAFTA apparel through Canada into the United States. Rules of origin would prevent Asians from going through Canada to get around American trade restrictions. This is an administrative cost that would reduce some of the advantages of the FTA. But there would be no loss of liberty or trade-offs of freedom.

*Open FTAs?* NAFTA also could face the problem of one of its members trying to block new entrants. For example, if Chile joins NAFTA, its wines will be more competitive in the United States in competition with Argentine vintages. Would Chile veto Argentine membership? Possibly, and for the same reasons Germany might resist Hungarian EU membership in the earlier example.

But as is the case with customs unions, the prospect—indeed, the inevitability—of future political battles over trade liberalization should not as such be cause to shy away from expanding a regional arrangement.

*What Diverts Trade?* Another problem with turning down freer trade for fear of trade diversion is that it is very difficult, before the fact, to determine whether thwarted wealth creation caused by trade diversion will offset new wealth creation that results from more open markets. That is because it is not possible to predict which enterprises will best serve the needs of consumers at any given time. Indeed, the whole point of having competition in a market is to separate successful from unsuccessful producers.

Furthermore, alleged trade diversion in the short term can be masked, indeed overwhelmed, by other factors. Exchange rates affect the international competitiveness of firms and the capacity of citizens and enterprises in a country to purchase imports. In



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the 1980s the U.S. economy was growing more rapidly than the economies of Western Europe and other countries. Thus, Americans imported more.

Recently, the erosion of America's trade surplus with Mexico has been blamed on NAFTA. But this erosion has had little to do with reduction of trade barriers or trade diversion. Rather, Mexico's irresponsible monetary policy and other policy failures led to the economic crisis that reduced Mexican purchasing power. It should be recalled that the United States bailed out Mexico in 1982 and, through the International Monetary Fund and World Bank, has continued to provide support for Mexico. Those policies, I would argue, were mistaken. But they took place at a time when America had no FTA with Mexico, when Mexico was not even a member of the GATT, and when Mexico's protectionist policies were particularly harsh.

If anything, it might be argued that closer economic ties with the United States have made it more difficult for Mexico to react to its self-inflicted crisis with the kind of self-destructive protectionist, nationalization, or confiscatory policies that often characterized its reactions to problems in the past.

*Missed Opportunities.* In the longer term, it is also difficult to determine where future opportunities to create more trade might lie. Fearing trade diversion, in the late 1950s some American policymakers might have turned down an offer by Japan to establish an FTA. Why divert trade from dynamic Europe or from the awaking economic giants of Latin America for not-so-promising Asian countries? We know now, of course, that had such an opportunity for a U.S.-Japan FTA arisen, and had America turned it down, it would have nothing to blame for decades of lost sales but the fatal conceit of putting political judgments ahead of market opportunities.

Another example offers proof of both the problems of predicting future markets, and of the role of a country's domestic policies as a major determinant of competitive international status. Weintraub observes that African countries benefited little from decades of GATT liberalization, whereas the four Asian tigers (Hong Kong, Singapore, South Korea, and Taiwan) benefited considerably. Quite true. Consider why.

Between 1965 and 1985 the combined GDP of Sub-Saharan African countries, minus South Africa, grew from about $100 billion to $200 billion in real purchasing power terms. Annual per capita income was stagnant over that period at about $500. If those countries had grown at the rate of the four Asian tigers during



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that 20-year period, in 1985 they would have had a total GDP of $648 billion and a per capita income of $1,800 (Hudgins and Johnson 1990). The repressive economic policies with which the African governments strangle their own people make it impossible for these people to breath the rich air of trade liberalization.

*The Regulatory Regime*

The foregoing discussion suggests that the role of regulation is more important to judging the wisdom of a regional trade arrangement than are strict trade effects. One of the greatest dangers to economic revitalization in the Western, industrialized countries, as well as to free trade, and certainly to economic liberty, comes from corporate statists of both the left and the right who wish to protect an increasingly untenable status quo.

The Western, industrialized democracies are currently experiencing a slow-motion version of the crisis that led to the collapse of the communist world. The contradictions of statist policies, including high taxes, heavy-handed government regulations, and government directions of economies, have produced economic, social, and political problems that cannot be mitigated by the same policies that caused these problems to begin with (see Hudgins 1994).

That situation is especially clear in Western Europe. Unemployment there is chronically twice as high as in the United States. Job creation, especially in the private sector, has been sluggish at best, in many cases nonexistent. Cutting-edge industries more and more are found in America and Japan. The latter countries also face systemic economic problems, though they might not be as obvious as they are in Europe. The federal regulatory burden on the American economy, for example, is estimated to be $600 billion annually. That is more than America's annual exports of manufactured goods.

To avoid systemic reform, political and economic elites in the United States, Europe, and elsewhere have a strong incentive to foist their own failed economic policies on newly emerging competitors via trade agreements. Naturally, these poison policies will be pushed in the name of creating a "level economic playing field" or "avoiding a race to the bottom."

Often that strategy is found in proposals to "deepen" free trade arrangements or to harmonize standards. The current struggle within the EU is over just such issues. Often the same negotiators will promote both sound and unsound policies. A deepening of trade that results, for example, in the elimination of "buy national" provisions or trade-distorting subsidies certainly is preferable to the status quo. But it should not be forgotten that one of the world's most costly and



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trade-distorting policies, the Common Agricultural Policy, is integral to the EU, consuming some three-quarters of the EU budget.

Thus, a non-EU country seeking admission would probably not find as great a danger from trade diversion as from the regulatory regime under which it might be forced to live as a condition of membership, or from the prospects of future, unsound policies being forced upon it. Swiss voters recently rejected association with the EU. Fear of such regulations certainly figured in that decision.

The regulatory baggage that a regional FTA might carry can involve a real loss of economic liberty as the price for freer trade. In such a case, a potential member must make a pragmatic judgment about whether the benefits in the short and medium term outweigh the drawbacks and whether the prospects in the future are for freedom from regulations or a heavier regulatory burden.

The most blatant example of exporting bad regulations is found in the side agreements to NAFTA. With these agreements, the United States attempted to force Mexico to move closer to American environmental and labor standards. American labor unions, for example, feared that less costly Mexican labor would result in American firms moving jobs south of the border.

Those agreements so far have not had the bite that proponents had hoped for or that opponents had feared. But expansion of NAFTA might indeed destroy more liberty than it creates if the environmental and labor provisions in NAFTA are expanded. For example, so far the U.S. Congress has not given President Clinton fast-track authority to negotiate entry of Chile into NAFTA. That is so partly because Clinton wants authority to force unsound environmental and labor standards on that country. Free trade advocates in the U.S. Congress would not go along with those demands. And Chile would do better to wait for a more free-trade-friendly administration than to accept what in the future could be crippling regulations.

*Lessons from American States.* It is instructive to observe what is beginning to happen within the 50 American states. The states are keenly aware of the magnitude of the regulatory burden that Washington imposes on them. Furthermore, they are well aware of the loss of their freedom to control their own affairs. For example, when a state government is forced to spend millions of dollars on some pollution-prevention program aimed at a problem that is of little danger to citizens in that state, or when a far less costly alternative is available, the state must deny or reduce other services to its citizens (e.g., police protection).

Furthermore, regulatory regimes differ from state to state. California, for example, has one of the worst regulatory regimes in the



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United States. In one case, Rohr Industries gave up its attempt to establish facilities in California, where the cost of license procedures would have been $750,000. It opted instead for Arkansas, where the license cost was $750 (Farah and Antonucci 1994: 24). Not unexpectedly, many California businesses have fled to neighboring Arizona and Nevada.

As federal regulations are reduced, the differences in regulations in the various states will become more economically significant. Countries considering membership in NAFTA or the EU can learn a lesson from the 50 American states. The ability of regulatory regimes to compete has several benefits. First, failed policies in one state or country will not necessarily harm its neighbors. Second, the competition from low-regulation states or countries will create incentives for others to change their policies.

*Race to Prosperity.* Some might call this a "race to the bottom" in which citizens will be exposed to debilitating pollution and dangerous working conditions. Even if there were some validity to this concern, balancing protection of public health and safety with other policy aims is best done within the various countries and states. Citizens do demand such protection. In countries such as Mexico, the need for jobs and economic growth mitigates some protective policies, as well it should. And as Mexicans and the citizens of other countries grow more prosperous, protection can be tightened without undue harm to the economy.

But such a model of tradeoffs between health and safety on the one hand and economic growth on the other is partly a result of government policies that purport to offer protection but that do so by harming the economy. There are, however, ways to protect health and safety through property rights, contract law, and reasonable tort law. The incentives in the 50 American states to consider such approaches are growing. FTAs can create incentives for countries to explore these approaches as well.

### *The Political Climate*

Domestic political problems are also key factors to consider when judging the wisdom of a trade arrangement. In the first three post–World War II decades in the United States, a consensus was found both among economists and policymakers in favor of freer world trade. Of course, during those years it was easier for policymakers to maintain such a view, because American manufacturers had few competitors in domestic markets and exports were often an afterthought. Protectionists in those days, and even in the first decade after the oil shocks of the 1970s, tended to be traditional rent-seekers,



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principally textile and apparel manufacturers or large, integrated steel producers.

But since the late 1980s there has been a serious erosion of the political foundations for free trade. That does not suggest that any coherent or reputable theory, empirical study, or school of thought has arisen to actually challenge the case for open markets. The problem is that popular leaders, commanding significant followings, defend protectionist policies out of populist zeal or a deep confusion about economic reality. Pat Buchanan and Ross Perot are the most prominent American examples on the right.

Added to the problem is the managed approach to trade with the United States as the principal practitioner. Under Presidents Reagan, Bush, and Clinton, that practice has grown. It has included so-called "voluntary" restraint agreements, quota restrictions on imports of autos, and steel quotas. It included the semiconductor agreement in which Japan agreed to restrict sales in the United States and also, according to the interpretation of the Americans, to guarantee certain percentages of the Japanese market for foreign suppliers.

The late Commerce Secretary Ron Brown's much-publicized trade missions fall into the managed trade category. They suggest that rather than seek more comprehensive market openings through WTO or regional arrangements, the heavy-handed, one-on-one approach is to be preferred.

How does neoprotectionism affect decisions on whether or not to join a regional trade arrangement? It suggests that if a country can quickly enter a good regional trade liberalization agreement without harmful regulatory strings attached, it should do so rather than rely on the longer-term multilateral approach. That is because a regional agreement will give rise in one's country to businesses and other interest groups with a stake in keeping the system opened. Those interests can help counteract the political influence of neoprotectionists.

## Conclusion

Bilateral or regional trade agreements that simply remove tariffs and traditional trade barriers are generally acceptable even if they divert some trade. First, such agreements increase economic freedom. Second, they actually hold less danger of being a vehicle for the export of failed regulatory policies. Third, it is difficult to determine before the fact what arrangements will be more trade diverting in the long term than the status quo.

Regional trade arrangements hold out better prospects for dealing with intractable trade problems than does the GATT/WTO mecha-



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nism, which usually must cater to the lowest common policy denominator. But the danger that deepening trade will simply deepen failed regulatory policies is also greater.

Bilateral and regional trade arrangements create incentives for nonmembers to join. This incentive effect is happening in the Western Hemisphere as traditionally protectionist countries come to understand the need to join NAFTA or remain poor or economically unstable.

But there is a similar relationship between regional and multilateral arrangements. NAFTA and the EU create an incentive for WTO countries to push ahead with further liberalization. If they do not, regional arrangements are likely to expand. It should be remembered that the American free trade areas with Israel and Canada resulted, in part, from the Reagan administration's frustration with multilateral trade problems. Another GATT round resulted in part because of the FTAs.

Unilateral, bilateral, regional, and multilateral trade liberalization are all valid means to achieve the goal that is the aim of market liberals: greater economic liberty.

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# Are Higher Alcohol Taxes Justified?

*Dale M. Heien*

Recently, economists have entered the alcohol policy arena by pointing out that consumption, and also abuse, may be reduced through price increases induced by taxation. Articles have appeared on various aspects of alcohol abuse, such as driving under the influence, youth alcohol abuse, and labor market effects. Many of those articles have the goal of estimating the elasticity of abuse with respect to a tax increase. The notion that abuse can be curbed by taxation has led to a call for increased taxes on alcohol. However, the economic justification for a tax increase is that it meet the social cost-efficiency criterion—that is, the marginal external cost of alcohol abuse should exceed the existing marginal tax rate. Although the studies referred to were well executed in terms of the particular focus and econometric technique, very little has been done recently to examine the justification of a tax increase in terms of social costs.

The question of the external cost of alcohol use, as contrasted with abuse, is complex and paradoxical. It is complex because there are two classes of consumers: abusers and moderate drinkers. Although externalities are associated mainly with abusers, both classes pay the tax because it is impossible to differentiate between abusers and moderate drinkers at the point of sale. Hence, a tax on alcohol is an externality for moderate drinkers. The main negative externalities are driving-under-the-influence (DUI) fatalities and injuries, increased medical insurance premiums, and the effect on social security funding of premature death.

The paradox of alcohol taxation arises because of the effect on the health and economic welfare of moderate drinkers. Although it is well known that excessive drinkers often have major health problems, it

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is less well known that moderate drinkers have above-average health, above the average of both abusers and abstainers alike. This phenomenon is referred to as the U-shaped curve.[1] Recent medical research has provided increasing evidence that moderate alcohol consumption is associated with a decreased occurrence of coronary artery disease (CAD) and increased longevity.

Readers are informed in some prominent health-related publications that moderate consumption may carry health benefits. Among those publications are the *Berkeley Wellness Letter* (May 1994), the *Harvard Heart Letter* (March 1994), the *New England Journal of Medicine,* and *The Healthy Heart Handbook for Women* (the NIH). CAD claims a half million lives annually with medical costs alone exceeding $60 billion.

Because it is impossible to levy taxes solely on abusers, tax increases will cause welfare losses for moderate drinkers through a reduction in consumers' surplus.[2] If moderate drinkers have lower medical care costs, medical insurance premiums will be lower for abstainers, resulting in a positive externality for nondrinkers. That insurance consequence, plus the loss in consumers' surplus, makes the calculation of the social cost of alcohol abuse alone inappropriate for evaluation of increased taxation.

The purpose of this article is to identify and quantify the positive and negative external costs of alcohol consumption, not just abuse, in order to evaluate the efficacy of a tax increase. The article relies on previous estimates of the effects on use and abuse of price increases, which seem quite reliable and accurately done. Following W. Kip Viscusi's (1994) analysis of the social costs of smoking, the article provides a range of estimates based on varying assumptions.

The article begins by looking at previous estimates of social costs of alcohol abuse and their methodology. Previous estimates of social cost have ranged from $9.3 billion to $130 billion. Next, the costs particular to DUI deaths and injuries and the subsequent issue of the value of a statistical life are analyzed. The following section deals with the welfare losses to moderate consumers. The impact of moderate and abusive drinking on medical care insurance costs are analyzed next. The last section examines these costs under various assumptions and draws some conclusions regarding the efficacy of taxation.

[1]In the more popular press, it is sometimes referred to as "The French Paradox" after the popular "60 Minutes" television program segment of the same name.

[2]According to evidence based on self-reporting of the American Psychiatric Association's *Diagnostic and Statistical Manual Mental Disorders*, 7.41 percent of the adult population abuse alcohol.



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## Previous Estimates of the Social Cost of Alcohol Abuse

The best known of these attempts are the various studies funded periodically by the National Institute of Alcohol Abuse and Alcoholism (NIAAA). The first such study, by Ralph Berry and James Boland (1977), set the methodological tone for those to follow. Successive studies done by the Research Triangle Institute for 1978 and 1983 were followed by a study for 1988. Updates of these estimates also appear periodically in special reports by the Secretary of Health and Human Services to the U.S. Congress entitled *Alcohol and Health*.

Dale Heien and David Pittman (1989) criticized the NIAAA methodology and demonstrated that the NIAAA estimates greatly overstate the costs through systematic bias and selective interpretation of the data. The nexus of the criticism is that the cost estimates do not follow the economic paradigm of external costs.[3] For example, the cost figures include the value of lost wages due to alcohol abuse and the value of the lives of drunken drivers. Those costs are incurred by individual choice and are not externalities. The value of lost wages accounted for over half of the total costs. Other problems with the NIAAA-funded studies were faulty statistical techniques, lack of overall accounting and methodological framework, continual use of the most liberal estimates despite the claim that only the most conservative estimates were used, and attributing causality to alcohol abuse where none had been shown to exist in the scientific literature.

Two recent studies have produced estimates that are consistent with the definition of social costs used in economics. The study by Willard Manning et al. (1991) bases the social costs of abuse on three main factors: DUI auto fatalities (excluding drunk drivers) and injuries, higher medical insurance premiums, and the effect of premature death on social insurance funds. In another study of the social costs of alcohol abuse, Heien and Pittman (1993) estimated the external costs to be $9.5 billion for 1985. The main difference between their findings and those of Manning et al. (1991) are the value of human life. Neither study took into account either the welfare cost on moderate consumers of tax increases or the effect of moderate consumption on medical insurance rates. This study deals with both these areas as well as taking a closer look at DUI deaths and injuries.

## External Costs of DUI Fatalities and Injuries

In 1993 there were 40,115 traffic fatalities in the United States. Traffic fatalities include pedestrians, pedalcyclists, and motorcyclists

[3]All of the NIAAA-sponsored studies refer to the costs as the "economic" costs of alcohol

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as well as automobile occupants. The National Highway Traffic Safety Administration defines two types of accidents involving alcohol. A fatal crash is defined as "alcohol-related" if either a driver or a nonoccupant had a blood alcohol concentration (BAC) of at least 0.01 grams per deciliter (g/dl). Drivers with a BAC of 0.10 g/dl or greater are termed "intoxicated." This level is the common norm for a DUI conviction. Using the intoxicated criterion, there were 13,984 fatalities in accidents involving an intoxicated driver or nonoccupant in 1993. This figure compares with 19,174 fatalities a decade earlier.

Leaving aside for the moment whether or not the externalities of DUI should be defined as those within the intoxicated or alcohol-related classes, there are more important distinctions to be made within both of these classes. Table 1 presents the various classifications of fatalities for the intoxicated driver crashes.

The foregoing classification presents a challenge as to which fatalities are externalities. Clearly few would argue that intoxicated drivers are an externality. They drink and drive of their own free will and bear the risks and consequences of doing so. Not surprisingly, the NIAAA estimates count the intoxicated drivers as an externality. Table 1 shows a large number of intoxicated drivers relative to the nonintoxicated ones. This result is attributable to the fact that the vast majority of DUI crashes involve one car. Similar considerations apply to the intoxicated nonoccupants category. Here, there are two main explanations: intoxicated pedestrians stray into traffic and intoxicated motorcyclists have single-vehicle crashes. The last category consists mainly of nonintoxicated bicyclists who are struck by intoxicated auto drivers. Hence, it is reasonable to classify the deaths of

*TABLE 1*

TYPES OF FATALITIES IN FATAL CRASHES INVOLVING AT LEAST ONE INTOXICATED DRIVER OR NONOCCUPANT: 1993

| Type of Fatality | Number | Percent |
|---|---|---|
| Intoxicated drivers | 7,578 | 54 |
| Nonintoxicated drivers | 938 | 7 |
| Passengers | 2,917 | 21 |
| Intoxicated nonoccupants | 1,936 | 14 |
| Nonintoxicated nonoccupants | 615 | 4 |

SOURCE: U.S. Department of Transportation (1993).

abuse. However, no definition of this concept is contained in any of the studies nor is any mention made of the concept of external costs.



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nonintoxicated drivers and nonintoxicated nonoccupants as externalities of drunken driving.

The real debate occurs over the classification of passengers. In most cases, it is not known if passengers are intoxicated or not. It is not relevant whether or not they are. The main criterion is whether or not passengers were in the car of the intoxicated driver or in the other vehicle. For those in the other vehicle, there is clearly an externality in just the same manner as the death of the driver is an externality. However, most occupants of a drunken driver's car are aware of the condition of the driver and exercise their own free will in choosing to ride with him or her.[4] Often they are related to the driver being either a spouse or children.

Published data exist for 1986 on the number of passengers who were in the drinking driver's car. Perrine et al. (1988: Table 6) indicate that 83.3 percent of the passengers were in the drunken driver's car. Applying that percentage to the foregoing 1993 figures results in 487 external deaths. The total external deaths are those 487 individuals, the 938 nonintoxicated drivers, and the 615 nonintoxicated nonoccupants. The total of those three groups is 2,040 individuals.[5]

The choice between alcohol-related and intoxicated is somewhat problematic. Numerous studies have shown that the relative risk of crash involvement rises with the BAC (Perrine et al. 1988). Those studies also show that the relation between risk and BAC is essentially flat until the .08 or .09 level for BAC (Hurst et al. 1994). Because .10 is the cutoff level for the intoxicated classification, it might be reasonable to take 20 percent of the alcohol involved crashes as being due to alcohol abuse. That assumption would result in total external deaths of 2,550.

There are human, vehicular, and environmental factors that interact with alcohol to contribute to accidents. Among them, the greatest amount of research has been done on the human aspect. Numerous studies have found that many of the personality traits that lead to reckless driving are found in alcohol abusers, especially among young drivers. On a per-mile-driven basis, fatal involvement is greatest for young drivers and for older drivers (Massie et al. 1995). Donovan et al. (1990) compared DUI conviction rates between a group of drivers with four prior traffic convictions or accidents within the last year and

[4]This assertion has some empirical verification in the study by Isaac et al. (1994). They found that where there were adult passengers, alcohol involvement by those passengers was high (80 percent).

[5]This figure compares with a total of 7,400 deaths in Manning et al. (1991: 97) and 5,760 in Kenkle (1993: 142). Part of the difference between their estimates and those above reflects the fall in DUI fatalities from 1986 to 1993.

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the general population in that age group. The "bad driver" group had over five times the DUI conviction rate of the general population group.

In a similar previous study, Donovan et al. (1985) studied three groups of male drivers: DWI (those arrested for DUI); HRD (those who had received multiple nonalcoholic traffic violations or been involved in an accident); and, GDP (general driving population). Attitudinal questions showed the HRD and DWI groups to be generally more deviant than the GDP group. The HRD and DWI groups did not differ significantly from each other on any of the measures of personality function or hostility. The authors concluded, "The noted similarities between the DWI and HRD groups are consistent with the contention that these two groups may represent subtypes within a larger population of high-risk drivers" (Donovan et al. 1985: 375).

No estimates exist of the number of alcohol-related crashes that would not have occurred if alcohol had not been present. However, drivers between the ages of 16 and 34 accounted for 61 percent of all drivers in fatal-alcohol related crashes.[6] Over 90 percent were males. If one assumes that this group has the same alcohol-relative odds as the older group, then 56 percent of the 16 to 34 age group fatalities were incorrectly ascribed to alcohol. Still, young males also drink proportionately more than older individuals. Adjusting for this fact results in an overstatement of 20 percent—that is, there are 20 percent fewer fatalities in this age group attributable to drinking. That adjustment results in a 12 percent reduction in external deaths caused by DUI.

A related area is that of the role of drugs either in conjunction with alcohol or used alone. Mercer and Jeffery (1995) studied blood samples from 227 fatally injured traffic victims and found that 43 percent had neither alcohol nor drugs, 37 percent had alcohol and no drugs, 11 percent had both, and 9 percent had drugs only. Although no attempt will be made to estimate the number of deaths attributed to drug abuse ascribed to alcohol, it should be considered that increases in alcohol taxes are likely to cause individuals to substitute drugs, which are not taxed, for alcohol.

Another aspect of the drunken-driver problem is that there are considerable injuries caused by DUI accidents and there is considerable property damage to the autos involved. Both factors should be treated in the same manner as deaths caused by DUI. Classification of external costs are the same here as for the fatalities and follows

[6]For the statistics on fatalities by age, see U.S. Department of Transportation (1993). For an analysis of age involvement, see Massie et al. (1995).



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the estimates of Kenkle (1993), with an update to 1993 for changes in medical care costs.

## Value of Statistical Lives

Whenever the abuse of alcoholic beverages causes a loss of life and that life is considered an alcohol externality, then the life must be valued to arrive at the cost of the externality. There are two main methodologies for computing the value of a statistical life. The first is the human capital method, a method that takes the earnings profile for the remaining years of the life and computes the present value of those earnings. The main advantage of this method is that it is the legal norm. Wrongful death suits use the human capital approach to compute compensation for plaintiffs.

A conceptually more satisfactory alternative is the "risk reduction" methodology. The difference between the wage in risky jobs versus safe jobs is taken as the measure of the compensation required to get workers to do risky jobs. By dividing this risk premium by the probability of death, one arrives at the value of life for that risk.

The standard approach is to estimate econometrically a hedonic wage equation based on individual data. Such estimates are subject to a number of problems. First, there are all of the standard econometric problems of nonexperimental data and mutual causality. Second, risky jobs tend to be unattractive (e.g., noisy and dirty). Hence, there may be a high correlation between the unattractive features of a job and the risk. Because those features are seldom measured, their effects are captured in the risk coefficient. If so, then the coefficients for an industry or occupation will overstate the risk premium.

Similar considerations apply to the estimate of the probability of death (risk) in an industry. Probabilities are based on historical frequencies that may or may not hold in the future or that may be based on inaccurate data. Also, there is a subjective element to probabilities that reflect risk. Some individuals may, through training, upbringing, or heredity, deal with certain risky situations better than other individuals.

Problems associated with the risk reduction approach are discussed in greater detail by Viscusi (1993). Although his article outlines many criticisms of the risk approach, it should not be misunderstood as being a refutation. Conceptually, this methodology is correct. However, there is great variation in the empirical estimates. The estimates given in Viscusi (1993) for air travel risk for standardized individuals range from a low of $0.8 million to a high of $29.4 million. Such variation does not inspire confidence in the estimates. Viscusi (1994) uses a value of life for nonsmoking victims of environmental tobacco

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smoke of $5 million for 1993. Although this value is the midpoint of studies reviewed by Viscusi (1993), it seems to be somewhat generous. Manning et al. (1991) use a value of $1.66 million ($1986) or $2.11 million ($1993), and Kenkel (1993a) uses $2.0 million ($1986) or $2.54 million ($1993). This study uses the $5 million value as an upper limit.

## Medical Insurance Externalities

Excess medical care costs for abusers are assumed to be passed along to nonabusers in the form of higher medical care premiums. Hence, estimates of the difference in medical care costs attributable to the cost of alcohol abuse must be made. The concept behind those estimates is to arrive at a statistical model of a "nondrinking drinker"—that is, an individual who is like an abuser in everyway (demographically, sociologically, and economically) but who does not abuse alcohol. However, econometric estimates using that approach are plagued by problems of unobserved components. Abusers lead lifestyles that include smoking, poor nutrition, and poor self-care in general. It is difficult to obtain samples where those traits are not present in abusers. Hence, alcohol becomes a proxy for them. Many abusers do not have insurance and pay for the care themselves, in which case it is not an external cost. Also, medical care is often paid for in a state or county hospital, or is paid through social security disability insurance. Although state hospitals are tax supported, the cost of running those institutions may not be an externality to taxpayers (Lee 1991).

The notion of excess medical care premiums is based on the finding that medical care costs for abusers are above average. Although that is true, it ignores the lower medical care costs incurred by moderate drinkers. Using the 1988 Health Interview Survey, Lewin-VHI (1994) has estimated the per capita medical care costs for all drinkers to be $3,295 versus $4,430 for nondrinkers. Those estimates are consistent with medical research findings on the relation between moderate alcohol consumption and health.

Over the past 20 years numerous studies have appeared in medical journals, indicating that moderate alcohol use is associated with reduced risk of CAD and greater longevity.[7] Those studies include the Harvard study by Rimm et al. (1991), Stampfer et al. (1991), Boffeta and Garfinkel (1990), and Klatsky et al. (1990). Because light to moderate drinkers have substantially lower rates of CAD and mortality than do nondrinkers or heavy drinkers, their medical care costs will be less.

[7]The main causes of CAD are smoking, high blood pressure, diabetes, and obesity. Death usually results from heart attack caused by blood vessel blockage.



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Those medical findings have been extended by several economists to examine the effect of alcohol on earnings. Given that moderate drinkers have better health and longevity than abstainers and abusers, it is reasonable to hypothesize that they also earn more. Articles by French and Zarkin (1993) and Heien (1995) confirm a U-shaped relation between earnings and alcohol consumption—that is, moderate drinkers earn more than abusers and nondrinkers.

In the study by Manning et al. (1991), taxes on earnings were approximately equal to the costs of collectively financed medical care for all discount rates. Considering that study, it seems reasonable to assume that taxes and medical costs are equal and cancel each other. Manning's finding can then be used as a lower limit estimate of the net medical care cost of alcohol abuse. The exact incidence of the effect of moderate drinking on health is complex, and a detailed analysis is beyond the scope of the present study. However, if drinkers as a class have lower medical care costs, then those costs will be a positive externality for abstainers. The Lewin-VHI figures suggest that the net savings in medical care costs (and hence presumably premiums) result in a positive externality for nondrinkers of $21.58 billion. That figure will be used as an upper limit for the external costs of alcohol use.

## Revised Estimates of the Social Cost of Alcohol Abuse

This section attempts to look at the range of social costs implied by the various foregoing estimates. The main areas of negative external costs are the value of the external lives lost and injuries attributable to DUI accidents and the increase in medical insurance premiums attributable to alcohol abuse, net of the social security not collected due to premature death of abusers. The main positive externality is the reduction in medical insurance premiums attributable to the health benefits of moderate alcohol consumption. As mentioned previously, estimation of social cost will be done under high and low assumptions to permit a range of estimates.

The estimated number of external deaths from DUI driving was 2,040 using the intoxicated driver criterion and 2,550 for the alcohol-related category. Those figures do not include the estimated 12 percent reduction for drivers who would have crashed even if they were not drinking. The alcohol-related figure less 12 percent, or 2,244, will be used as the lower estimate. The upper estimate will follow Kenkle (1993) and take one-half of the alcohol-related passengers as external and make no adjustment for those who would have crashed anyway.

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That method results in 3,765 external deaths.[8] When the external cost of injuries resulting from DUI crashes is calculated on a pro rata basis, using Kenkel's figures updated by the CPI for medical care, the result is an upper limit of $6.18 billion and a lower limit of $3.68 billion.

As previously discussed, the value of life of $5 million used by Viscusi (1994) could be considered somewhat high given the problems of omitted variables in measuring the risk premium and in view of estimates used by Kenkel (1993) and Manning et al. (1991). The CPI updated value of Kenkel's estimate of the value of life is $2.54 million. That figure will be used as the lower bound and Viscusi's estimate of $5 million as the upper bound. Applying those upper bounds of the values of life and the DUI fatalities gives an estimate of the fatal DUI externalities of $18.83 billion. Following the same procedure for the lower limits gives an estimate of $5.71 billion. Next, the external cost of DUI crash injuries is estimated to be $6.18 billion for the upper limit and $3.68 billion for the lower, which gives total costs for upper and lower bounds of $25.00 billion and $9.39 billion. This article follows the result found by Manning et al. (1991) that the increase in medical insurance premiums are exactly offset by the loss in uncollected social security benefits. Hence, the total positive external costs of alcohol use range from $9.39 to $25.00 billion.

Table 2 presents the totals for the upper and lower positive and negative external costs and contrasts those costs with the current level

*TABLE 2*

POSITIVE AND NEGATIVE EXTERNAL COSTS
(BILLIONS OF DOLLARS)

| | Lower Estimate | Upper Estimate |
|---|---|---|
| External costs | | |
| DUI crashes | −9.39 | −25.00 |
| Medical insurance | 0.00 | 21.58 |
| Total external cost | 9.39 | 3.42 |
| Tax revenues | 17.97 | 17.97 |
| Inefficiency level (difference) | 8.58 | 14.55 |
| Consumers' surplus loss | 8.92 | 15.13 |
| Deadweight loss | .34 | .57 |

[8]It should be noted that the 3,765 estimate is considerably lower than Kenkel's estimate of 5,760. His estimate is for 1986, mine is for 1993. There has been a dramatic fall in the number of DUI fatalities over the 1986–93 period.



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of taxation of $17.97 billion.[9] The upper value in the DUI category reflects a greater value of life ($5 million versus $2.54 million) and greater external deaths (3,765 versus 2,244). The difference between the upper and lower estimate in the medical insurance category is simply the lower cost of medical insurance premiums for nondrinkers. Tax revenues exceed the external costs in both the lower and upper limit cases. Hence, the externalities of alcohol use, when properly framed, are more than accounted for by current levels of taxation.

Because the taxation levels are too high, prices are higher than they should be for social efficiency and there is a loss in consumers' surplus. Hence, it is appropriate to compute the loss in consumers' surplus attributable to those excessive taxes. The loss of consumers' surplus is offset by the level of tax receipts in excess of that needed to cover the externality. That loss is given in the next to the last row of Table 2.[10] The last row gives the deadweight loss—that is, the difference between the efficiency loss and the loss of consumers' surplus. The deadweight loss may in fact be much larger depending on the efficiency with which the government uses the tax receipts.

What accounts for the reversal of the results from previous studies? Several factors are prominent. First, the number of alcohol-related fatalities and injuries have declined by 26 percent since 1986, the date of the previous study. On the other hand, the value of life and injury costs have risen. Those opposing forces resulted in a DUI cost of $25 billion based on the same definition of an externality, of $25 billion, which is close to the $20 billion figure found by Manning et al. (1991) in their study based on 1986 data. Another major factor is the increase in alcohol tax receipts as a result of the 1991 federal excise tax increase on alcohol. Finally, the current study accounts for the reduced medical care costs for nondrinkers resulting from lower costs to moderate drinkers. The more stringent definition of DUI externalities given by the lower bound plays a role, but only for the lower bound.

The foregoing analysis results in the conclusion that *total tax revenues exceed total external costs by at least $8 billion*. As long as second order conditions are satisfied, marginal positive external costs are much less than marginal tax rates if their respective totals are nearly

[9]This total is composed of $7.6 billion federal excise tax receipts, $3.6 billion state-and-local excise tax receipts, $4.57 billion state sales taxes, and $2.21 billion local property taxes. The total does not include liquor license and distribution fees.

[10]An estimate of $-0.7$ was used for the elasticity of demand. That estimate came from Manning et al. (1995) and also conforms with other econometric studies.



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equal, as shown. Thus, on the basis of the analysis, there is every reason to believe that the level of taxation is far beyond the point of social efficiency.

## The Historical and Fairness Standards

A recent article by Cook and Moore (1993) presented two new rationales for increased taxation on beverage alcohol. Those are the historical standard and the fairness standard. The historical standard says that alcohol taxes should be maintained at their (real) historical levels and not be allowed to be eroded by inflation. Because alcohol taxes are generally levied on a per gallon basis and are not ad volarem, that standard seems to have some validity. However, there are two strong arguments against the historical standard. First, the result will depend on what date is chosen as the historical reference. Cook and Moore choose 1951, the last time excise taxes were raised. Had an earlier date been chosen, the result would have been different. More important, their approach ignores the substantial increase in other alcohol taxes over the period. Sales and excise tax rates at the state and local levels have increased substantially over the postwar period so that the overall real tax rate on alcoholic beverages has not declined.

The fairness standard is derived from three criteria: (1) the "horizontal equity" criterion (equals should be treated equally); (2) the vertical equity criterion (unequals should be treated differently, so people with greater ability to pay taxes should pay more than lower income people); and (3) households that receive greater government benefits should be taxed higher. On the horizontal equity criterion, a tax increase will fall equally on moderate drinkers, who are not the source of the externalities, as well as the abusers. That criterion is, in effect, no different than taxing abstainers for the costs of alcohol abuse.

The violation of the vertical equity criterion is even more obvious. It is generally conceded that alcohol taxes are regressive—that is, they bear more heavily on poor people because lower-income individuals tend to drink more, and alcohol taxes are levied on a quantity basis (e.g., dollars per gallon).[11] The finding that expenditures on alcohol tend to be a constant fraction of income is based on the fact that consumers demand better quality as their incomes rise.

Finally, the criterion concerning receipt of government benefits is reasonably clear. Cook and Moore (1993) state that alcohol abusers clearly receive more from government programs than do others.

[11]The regressivity of alcohol taxes has been reaffirmed in a recent study by Lyon and Schwab (1995).



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Nevertheless, the really interesting fact about the fairness standard is that it says noting about what the level of taxation should be. It addresses only how the burden should be distributed.

## The Public Health Approach

In addition to the three standards—social cost, historical, and fairness—another standard exists for measuring the cost of alcohol abuse, namely the public health standard (Cook 1990). This standard is used by the NIAAA and attempts to measure the economic cost of alcohol abuse. The problem with this approach is that it is inconsistent with Western notions of individual freedom and responsibility. Under the public health standard, actions that harm only the abuser or his family are lumped together with true external costs. The resulting costs are quite high—$130 billion for the United States in 1990. The analysis by Heien and Pittman (1989), however, strongly questions the validity of such calculations and notes that many of the inseparable effects on moderate consumers are ignored—including the impact on social security funding and the health aspects of moderate drinking.

## Conclusion

Recent articles by some economists have called for increased taxation of alcoholic beverages. The evidence presented here indicates that the net external costs of alcohol do not exceed the current level of taxation. Much like the case for the taxation of tobacco (Viscusi 1994), the rationale for a tax increase on alcohol does not pass the social-cost test when all costs, including those imposed on moderate drinkers, are juxtaposed against the current levels of taxation.

Alcohol bashing has become one of the "feel good" issues of the 1990s. Alcohol consumption and alcohol abuse are declining by any objective measure. The implied notion that alcohol consumption is sinful is a moralistic one and not supported by objective analysis. The very title, "sin taxes," plays on the old moralistic sentiments that led this country to the disastrous policy of prohibition.

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# Federalism and Individual Sovereignty

*James M. Buchanan*

I have been both surprised and disturbed by two sources of opposition to efforts to move toward federalist structures in which political authority is divided between levels of government. I refer, first, to the opposition in Europe, mainly in Britain, to movements toward effective European federalism. Second, I refer to the successful agitation that blocked the proposed Conference of the States in the United States in 1995. What is disturbing about these sources of opposition to the very idea of political federalism is that both emerge from groups that are identified variously to be right-wing, conservative, or libertarian. We should not, of course, be surprised at all by socialist-inspired opposition to the federalist idea and ideal. Socialists have been and remain forthright in their desire to extend the range of politicized control over the lives and liberties of persons. But why should conservatives, classical liberals, or libertarians join socialists in opposing structural reforms that embody federalist principles?

I suggest that a coherent classical liberal must be generally supportive of federal political structures, because any division of authority must, necessarily, tend to limit the potential range of political coercion. Those persons and groups who oppose the devolution of authority from the central government to the states in the United States and those who oppose any limits on the separate single nation-states in modern Europe are, by these commitments, placing other values above those of the liberty and sovereignty of individuals.

The incoherence in values that such anti-federalist ambivalence reflects is not widely acknowledged. The relationships between federalist political structure and the sovereignty of the individual must be

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carefully examined, particularly in terms of the implications for current discussions in Europe, Mexico, and the United States.

In this paper, I shall summarize the theory of competitive federalism and examine the relation between the engagement-participation of the individual in politics and the size of the political unit. The theory of competitive federalism emphasizes the prospects for exit, both internal and external, as constraints on political control over the individual. In contrast, the theory of what we might call "partitioned sovereignty federalism" emphasizes the prospects for the exercise of voice in limiting political excesses.

In addition, I shall introduce moral elements that may emerge in arguments for federal political structures and relate those arguments to observed crises in modern welfare states. Finally, I shall apply the analysis more directly to discussions of movements toward federalist structures in several parts of the world.

## The Theory of Competitive Federalism

The normative theory of competitive federalism is congenial to economists in particular, because it is simply the extension of the principles of the market economy to the organization of the political structure. The market economy produces high levels of value from which all participants benefit; persons are legally guaranteed rights of entry into and exit from production and exchange relationships one with another. If a good or service offered by a producer-seller is "bad" compared with goods offered by other producer-sellers, the prospective purchaser-consumer simply exercises the exit option and shifts his or her business to an alternative supplier. And the facts that profits are promised by marketing "good goods" rather than "bad goods" ensures that scarce resources will flow toward those uses that yield relatively high values. Suppliers remain always in competition among themselves, faced with the knowledge that demanders have available the continuing prospect of exiting from any ongoing economic relationship.

Normatively, the political structure should complement the market in the sense that the objective for its operation is the generation of results that are valued by citizens. By its nature, however, politics is coercive; all members of a political unit must be subjected to the same decisions. The prospect of exit, which is so important in imposing discipline in market relationships, is absent from politics unless it is deliberately built in by the constitution of a federalized structure.

Consider a large economy, characterized by liberty of resource flows and trade throughout the territory—liberty that is enforced by



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a political unit, a government, that is coincident in extent with the effective size of the market. If politics could be restricted to the exercise of these minimal or protective state functions (the night watchman state), little or no concern need be expressed about coercive political intrusions on the liberties of citizens. As the experience of this century surely demonstrates, however, politics is almost certain to extend beyond any such limits. (We need not argue here about whether or not and to what extent expansions in the domain of politics are justifiable.) The problem becomes one of organizing the beyond-minimal politics of the "productive" and the "transfer" state so as to minimize the potential for political coercion or, stated conversely, to maximize the protected sphere of individual sovereignty.

It is here that the prospects for organizing the polity in accordance with federalist principles become exceedingly attractive. Federalism offers a means of introducing essential features of the market into politics. Consider, for example, a setting in which the central or federal government is constitutionally restricted to the exercise of minimal or protective state functions, while all other functions are carried out by separated state or provincial units. The availability of the exit option, guaranteed by the central government, would effectively place limits on the ability of state-provincial governments to exploit citizens, quite independently of how political choices within these units might be made. Localized politicians and coalitions would be unable to depart significantly from overall efficiency standards in their taxing, spending, and regulatory politics. And note that the feedback effect of potential exit need exert itself only on a relatively small share of economic decision takers. Even those citizens who might never consider migration in some Tiebout-like regime would be protected by the acknowledged existence of those few citizens who might be marginally sensitive to differential political treatment. Federalism serves the dual purposes of allowing the range or scope for central government activity to be curtailed and, at the same time, limiting the potential for citizen exploitation by state-provincial units.

## Partitioned Sovereignty Federalism: The Exercise of Voice

The efficacy of competitive federalism depends directly on the operative strength of the exit option. The ability of persons to migrate and to shift investment and trade across boundaries serves to limit political exploitation. Recall, however, that in his seminal work, Albert Hirschman (1970) placed "voice" alongside "exit" in his examination of control institutions. In the market, exit is the dominant means



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through which persons indirectly exercise control, and, as indicated earlier, federalism incorporates this means into politics. But the exercise of voice is also important, especially perhaps in politics, and this feature lends independent support for federal structures.

The basic logic is straightforward. If the concern is for the protection and maintenance of individual sovereignty against the potential coercion that may be imposed by political or collective action, the size of the political unit, measured by the number of members, becomes a relevant variable, quite apart from the presence or absence of an exit opportunity. And political authority may be deliberately shared between a central government and component units, with effective sovereignty partitioned among levels.[1]

Consider, again, a large economy in which a central government, coincident in size with the economy, is limited to the carrying out of protective or minimal state functions. How should the extensions of political activity beyond these limits be organized? How should the public-goods and welfare state activities be structurally designed?

Even if citizens are predicted to remain locationally fixed, and hence within a single jurisdiction, so that exit is not a potentially effective means of institutional control at all, there remains a strong normative argument to be made for establishing relatively small, and coexisting, political units, all of which may be geographically contained within the boundaries of the economic interaction and the territorial reach of the central government. If persons are, for any reason, either unable or unwilling to exercise the exit option, actually or potentially, they may be able to exercise voice, defined here as activity that is participatory in determining political choices. And voice is more effective in small than in large political units. One vote is more likely to be decisive in an electorate of 100 than in an electorate of 1,000 or 1 million. Also, it is easier for one person or small group to organize a potentially winning political coalition in the localized community than in a large and complex polity.

But voice is more than a vote in some precise mathematical formula for measuring potential influence over political outcomes. Neither the set of alternatives among which political choices are made nor the preferences of citizens-voters are exogenous to the processes of political discussion. And it is self-evident that the influence of any person in a discussion process varies inversely with the size of the group.

Even if exit is nonexistent in reality, what we may label as "virtual exit" may be important and relevant in the internal discussion-choice

[1]Roland Vaubel (1995) makes several of the same points that I emphasize here. Notably, Vaubel also used the "exit" and "voice" metaphors in the federalist context.



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process. The mere fact that coexisting units of government exist and can be observed to do things differently exerts spillover effects on internal political actions. As a practical example, even though exit was of some importance, especially in Germany, the *observations* of Western economies, culture, and politics by citizens of Central and Eastern Europe were independently critical in effecting the genuine political revolutions that occurred in 1989–91. As an additional conceptual experiment, think about how much less vulnerable the communist regimes would have been if all of Europe had been under communist domination. Or imagine how prospects for the revolution might have fared in a world without television.

Note that the normative arguments for federalizing political authority made so far have not considered the relative economic efficiency of public goods delivery by the different levels of government. Those arguments suggest that, even if productive-welfare state functions could, in some ideal sense, be best carried out by the central government, there are offsetting grounds, based on what we may call "political efficiency," for partitioning political choice (see Brennan and Buchanan 1980: Chap. 9).

## Homogeneity, Moral Capacity, and Federalization

The effects of community size on the individual's protection against political exploitation discussed so far are independent of any consideration of the homogeneity or heterogeneity of the constituent members of the separated state or provincial units. Even if the inclusive polity is made up of similar persons, there remains a normative argument for partitioning effective political sovereignty between central and state-provincial units of governance. If, however, we now introduce prospects for heterogeneity in the inclusive constituency, the argument for federalization is surely strengthened. Small units, defined geographically or territorially, are likely to be more homogeneous in makeup than larger units, and the individual is more likely to share preferences for political action with his or her peers than would be the case where political interaction must include persons who are considered to be "foreign," whether the lines here be drawn racially, ethnically, religiously, economically, or otherwise. If the end objective is the minimization of politically orchestrated coercion, the individual will, personally, feel under less potential threat in a community of similarly situated peers than in a large community that embodies groups with differing characteristics.

Quite apart from the objectively identifiable characteristics that might allow an outside observer to classify persons into groups, the

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size of the community also becomes relevant in its direct relationship to the moral capacity of the individual to share values with others. That is to say, homogeneity in values among persons may itself be related to social and locational distance. And those values may include community bonding, which may be expressed in terms of utility interdependence. A person may feel genuine empathy for other persons whom he or she classifies, internally, as members of his or her moral community, the boundaries of which are determined, in part, by numbers and by proximity. For example, I may share a common concern for the plight of persons who are citizens of Montgomery County, Virginia, or, more inclusively, for the plight of the citizens of Virginia, a concern that is either absent or much attenuated with reference to the citizens of Kern County, California, or of California itself.

In a paper that I presented at the American Economic Association meetings several years ago (Buchanan 1978), I argued that each of us has only a limited moral capacity. It is surely easier and more natural to feel sympathy for and care about others who are members of the same small community than it is to care for members of a large polity. I suggested, further, that a major factor in generating the breakdown of the welfare state was the shift of transfer activities to the central government and away from local communities in which political action might well embody a greater sense of interdependence. I suggested that the shift of political activities that must incorporate moral elements to levels of interaction that extend well beyond our moral capacities can only serve to exacerbate the emergence of raw self-seeking by groups of potential clients on the one hand and by those who feel unduly exploited on the other.

The argument here is, of course, related closely to F. A. Hayek's emphasis on our genetic heritage, which is basically tribal, and leads us to classify other persons into two groups—"us" and "them," or "neighbors" and "strangers." Hayek (1979) perceptively noted that only as these genetic dispositions came to be transcended by the culturally evolved norms for generalized reciprocity in interactions did the "great society," defined by the extended market order, become possible. We must recognize, however, that politicization, in itself, explicitly encourages the reemergence of tribal identities. Political action, regardless of how decisions are made, involves choices that are made for, and coercively imposed on, *all* members of the relevant political community. Anyone who is a participant is, almost by necessity, required to classify his or her own interests in juxtaposition against the imagined interests of others in the polity. Federalized structures allow for some partial mapping of politics with tribal identities. At



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the very least, federalized structures reduce the extent to which tribal identities in politics must be grossly transcended. This consideration assumes relatively more importance if and as the moral linkages are locational, rather than strictly genetic.

## Federalism as an Ideal Polity and Federalism in Reality

It is relatively easy to describe the ideal structure of politics for a large community, defined by territory or by numbers of citizens, if the overriding objective is the protection of individual sovereignty against political coercion.[2] A central government authority should be constitutionally restricted to the enforcement of openness of the whole nexus of economic interaction. Within this scope, the central authority must be strong, but it should not be allowed to extend beyond the limits constitutionally defined. Other political-collective activities should be carried out, if at all, by separate state-provincial units that exist side-by-side, as competitors of sorts, in the inclusive polity.

This definition of the idealized federalism is useful only because it offers a concrete objective toward which reforms in political arrangements may be directed. In reality, no existing political structure comes close to the ideal. Any constructive effort must therefore commence with an understanding of and appreciation for the politics that is observed to exist. "We start from here and now." This elementary fact should always be prefatory to any discussion of reform.

With reference to the common federalist ideal, however, we may observe categorically different starting places. The situation may be represented by the spectrum in Figure 1, in which a federal political structure stands halfway between a regime of fully autonomous states on the one hand and a monolithic, all-powerful central authority on the other.

Individual protection against political exploitation is increased as we move toward the center of the spectrum from starting points either left or right of center. In 1787, James Madison sought to increase the authority of the central government; he located the status quo under the Articles of Confederation somewhere to the left of center in Figure 1. He sought to increase the authority of the federal government as a means of placing limits on the authority of the separate states. We know now that United States history has destroyed Madison's vision. As a result of the destructive Civil War in the 1860s, secession was permanently eliminated as an effective extra-constitutional check

[2]The discussion in this section closely parallels that in Buchanan (1995).



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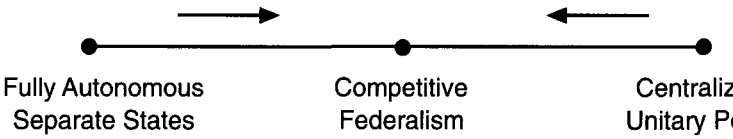
on the progressive increase in central government authority. And, in the 20th century, constitutional guarantees against federal encroachment on the authority of states were undermined by executive, legislative, and judicial departures from established principles. At the century's end, therefore, the status quo is clearly on the right side of the spectrum in Figure 1. Effective reform must embody devolution of power from the central government to the states—change that is in the opposite direction from what Madison accomplished in 1787.

*FIGURE 1*

A CONSTITUTIONAL REFORM SCHEMATA




In Mexico, the situation is similar with respect to the direction of change, despite the categorically different history of the country. Reform in the direction of securing effective federalism must incorporate a devolution of authority toward the states and away from the central government.

In Europe, however, matters are quite different. There the status quo exhibits some features that are analogous to those assessed by Madison in 1787. The opportunity has existed, and still exists, to organize European politics so as to put in place a genuine federal structure with many elements of the ideal set out earlier. The Europe-wide economy has been substantially integrated, with historically unprecedented liberties of resource flows and trade across traditional national boundaries. Reform requires the establishment of a strong but limited central authority, empowered to enforce the openness of the economy, along with the other minimal state functions. In this way, and only in this way, can the vulnerability of the individual European to exploitation by national political units be reduced. At the same time, however, the extension of the central authority's powers beyond such minimal limits must be rigidly opposed. The separated nation-states, as members of the federal union, must zealously protect the whole range of subminimal political activities.

Opposition to the federalist idea, especially as expressed in arguments by some U.K. political leaders, stems from an imagined fear of a monolithic central authority in Brussels—a fear that has been fueled, in part, by the residual vestiges of the socialist mentality among some influential nominal supporters of the federal structure. Both attitudes fail to understand that federalism and socialism are contradic-



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tory systems of political order. Federalism is a means of reducing political power overall and of dividing the power that exists. Socialism is opposed on both counts.

The opposition to federalism that comes from those who otherwise seem sympathetic to classical liberalism apparently reflects a failure to understand that federalism offers protection against the excesses of the autonomous nation-state. Or could it be that the genuine objective of those who oppose reforms toward federalism is not individual liberty, but rather the preservation of national political sovereignty? It is as if the U.K. anti-federalists are saying, "We do not mind being politically coerced, so long as it is done by the British Parliament."

The position of those zealots in the United States who successfully thwarted the organization of the Conference of the States in 1995 is even more bizarre and surely borders on paranoia. The initiative behind the Conference was aimed almost exclusively toward designing ways and means through which effective political authority could be devolved from the federal government to the separate states. How could those persons and groups who mouth slogans about liberty and oppose such initiatives be other than dishonest or ignorant?

## Postscript: Individual Sovereignty and Individual Liberty

Note that my title is "Federalism and Individual Sovereignty" rather than "Federalism and Individual Liberty." It may be useful to clarify the distinction. What is the ultimate maximand when the individual considers the organization of the political structure? Unless he or she is a genuine anarchist who thinks that private and voluntary action can be efficacious over the whole social space (including basic protections to person, property, and contract), this maximand cannot be summarized as the maximization of (equal) individual liberty from political-collective action. Implementation of such an objective would, to many of us, represent a leap backward into the Hobbesian jungle.

A more meaningful maximand is summarized as the maximization of (equal) individual sovereignty. This objective allows for the establishment of political-collective institutions, but implies that these institutions be organized so as to minimize political coercion of the individual. Coercion is defined as being required to do things or to submit to things others do to you, that you do not, or would not, voluntarily agree to do yourself or to have done to you. A person may give up his or her liberty to steal from others and pay taxes to support the enforcement of laws against theft provided others are subjected to the same general constraints. So long as one's agreement to such

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political action is voluntary, the individual's sovereignty is protected, even though liberty is restricted (see Buchanan and Lomasky 1984).

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# Federalism and Individual Sovereignty: Comment on Buchanan

*Jean-Luc Migué*

James Buchanan has succinctly restated the Tiebout tradition of federalist analysis. The foremost contribution of federalist structures is to minimize political coercion in society and thereby to promote the advancement of human liberty. As Buchanan (1995/96: 260) puts it, "competitive federalism . . . is simply the extension . . . of the market economy to the organization of the political structure."

Although most economists, if not most observers, would agree that the entry and exit process is the determining feature of federalist structures, I feel obligated to bring out the limits of that arrangement in contemporary national federations. The downside to the competitive process as envisioned in "idealized federalism," writes Buchanan (ibid.: 265), is that "no existing political structure comes close to the ideal." As Buchanan argues, once constitutional limits to the power of the central government break down, as occurred in all federations in the last 50 years, the benefits of intergovernmental competition also evaporate. I now wish to argue that the consequences can be worse than monopoly government.

## Limits to National Federalism

In the Tiebout analytical tradition, resource mobility through decentralization offers a substitute to, not a transformation of, the political process, as the instrument to discipline governments. Economic agents can choose the administrative location in which to place their assets rather than seek to influence government directly. Individuals and firms act in their capacity as asset owners rather than as voters or

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political actors in their attempt to maximize value. But the voice process itself is not essentially changed. The fact is that public choice analysts assume that the working of the political process under federalism remains the same at all levels of government as in unitary regimes. The exit mechanism is merely superimposed on politics as a constraint on decentralized authorities. It can therefore be argued that there is no specific economic theory of federalist politics. Only indirectly is the analysis of federalism related to the public choice tradition. Such an argument carries analytical implications in conditions in which "constitutional guarantees against federal encroachment on the authority of states were undermined by executive, legislative, and judicial departures from established principles" (ibid.: 266).

The Tiebout theory of federalism is based on the assumption of firm constitutional limits on the powers of the federal government. Once the division of powers breaks down, the functions of the two levels of government overlap more and more. Taking Canadian modern history as a case in point, Ottawa, along with the provinces, is active in most fields that constitutionally are the sole jurisdiction of the provinces: namely, manpower training and apprenticeship, social services, culture, housing, tourism, and sports and recreation. For the past 40 years, the federal government has shared with the provinces in the cost and implementation of the most rapidly expanding programs, such as medicare, higher education, and welfare. And of course equalization programs, which by nature affect all provincial fields, must also be included in areas of overlap. Taken together, these fields account for the bulk of the modern expansion in public budgets. The irony of it all is that despite the overwhelming role taken on by our central government, a large current of opinion in Canada holds that Canada is the most decentralized federation in the world.[1]

In fact, everywhere today national federations find themselves in a situation in which two or more levels of government compete for the same voters in the supply of similar services in a given territory. By analogy, with the extraction of oil from a common pool by two or more producers, direct competition for votes by two levels of government gives rise to a common-pool problem. If one views votes as inputs in the production of political outputs, then it is in the interest of both government suppliers to seek to gain the votes in implementing programs first. Should one of them abstain from supplying the political output, the potential gain of votes would be lost in favor of its competitor. Competition in the absence of property rights results in waste through rent-seeking. Competition between two vertically structured

[1]For a recent restatement of this position, see Andrew Coyne (1995: D5).



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governments leads each one to attempt to realize the net political benefits for fear of losing them to its competitor. Yet, ex post, the political profit is dissipated for both.

One consequence of this process is a tendency for all levels of government to oversupply and to overregulate—in fact, to coerce potentially more than monopoly governments. Here is an implication of public choice under federalism that runs counter to predictions derived from the more familiar Tiebout line of analysis. That means there are two forces operating in a typical modern federal system, a coercive-expansionist force rooted in the political dynamics analyzed here and a restrictionist force based on the mobility of resources among decentralized entities. This distinction may explain why the empirical record is rather mixed on the contribution of federalism to containing government growth.[2]

## A New Federalist Order

Despite the limits that history has placed on the action of federalism, I suggest that optimism remains the order of the day. Contemporary movement toward freer trade in goods and factors and toward common-market arrangements throughout the world provides a unique opportunity to overcome the drawbacks of monopoly government as well as the common-pool problem of multilevel government competition. The power of national governments to coerce in traditional federations mainly originates from a central government having the power to rule over the whole national area behind trade barriers. Now it seems that protectionism is no longer a viable alternative. In the last several years, various GATT-type arrangements, common-market treaties, and other freer-trade agreements within blocs have acted to constrain the power of national governments to maintain trade barriers.

Once protectionist impediments to exit are removed, national governments find themselves in the approximate position of a province or a state or a canton vis-à-vis the national economy in a federal state. The Tiebout mechanism comes into play, not mainly as a result of a new consensus on the virtues of limited government, but because the national government loses its traditional powers to rule over society and regulate the economy. The monopoly power of unitary governments, as well as the common-pool problem of federalist politics, can be alleviated to the extent that free movement of resources allows resource owners to move away from excessive taxes and regulations.

The determining characteristic of a federalist structure is extended to the international economy to the extent that responsibilities are



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entrusted to authorities that have no power to tax or regulate the whole area in which trade is free. Not surprisingly, opposition to the North American Free Trade Agreement (NAFTA) came largely from Canadian and American environmentalists and organized labor, who feared increased competition from the expansion of opportunities in Mexico. That means that in most countries of this hemisphere, certainly in countries of the European Union and of North America after NAFTA, residents can more easily escape the burden of monopoly governments or multilevel competition either by purchasing their supply outside the country or by moving their assets or their person to neighboring countries offering more favorable legislation. Asset owners voluntarily enter the association endowed with the power to rule over them.

## Free Trade as the Driving Force behind Government Withdrawal

I submit that the global movement toward free trade in the Americas, in Europe, and generally throughout the world after five rounds of successful GATT negotiations, is the real force working in favor of government withdrawal. This force of freedom, more than intellectual and technological changes, more than the realization that governments do not work, more than the intellectual awareness of the virtues of limited government, seems to be the dynamic behind the modern shift to "conservatism."

That such a movement is taking place can hardly be denied. It is visible everywhere in the greater reliance placed on freer markets, on the profit motive, on the sovereignty of the consumer, in the greater responsibility of people to take care of themselves and their families, and on the right of people to keep for themselves more of the fruit of their efforts. In turn, there is less reliance on progressive and higher taxes, on extensive social programs, on public enterprises, and on bureaucratic regulation of the behavior of workers and enterprises.

Even a traditionally social democracy like Canada cannot, after NAFTA, escape the trend away from interventionism. Deficit reduction by spending restraint dominates fiscal policy debates. Our traditional docility toward rising taxes seems to have waned. The pace of privatization is still lively. Government bailout of business has lost its appeal. Public opinion seems to be solidly behind reforms of unemployment insurance and welfare.

## Nationalism as a Rationale for Decentralization

Buchanan deplores the fact that Europeans, the British in particular, readily accept being coerced, provided the coercion originates from



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their own national government. That suggests that one should take a more philosophical approach to the question of nationalism as a rationale for decentralization. The public choice tradition has taught us to give little weight to how people rationalize their political and constitutional position. What matters more is that real forces and incentives work in the desired direction.

Economic analysts, and all free people, for that matter, need to resign themselves to an objective fact: that the competitive virtues of federalism, which serve as the basis for their enthusiastic support for this structure of government, are not a popular vision. Whether in Europe or in national federations, people can hardly conceive of their elected national government as not striving for the common good. How can a candidate to elective office elicit enthusiastic support for his or her candidacy to a necessary but failed, if not evil, institution? Just recently, in my own province of Quebec, half the population was ready to jump into the catastrophic unknown of secession as a result of their faith in their provincial government. Not once in the referendum campaign were the competitive dimensions of federalism even mentioned by the defenders of the federalist structure. The partisans of secession, as good social democrats do everywhere, even made their case for separation as a shield against the "right wing" forces now invading the rest of America and threatening the Canadian social programs. Even in the recent confrontation over the budget between the Congress and the President, the virtues of competitive rivalries between component governments were seldom invoked. Rather, the movement was based on the belief that states can do a better job because they are closer to the people.

Although intellectually disappointing, the appeal of devolution to nationalist forces need not depress federalists. There is an upside to that state of affairs. In common markets and free trade areas, people's faith in their own national government can serve as a protection against the risk of repeating the history of overcentralized national federations. That is clearly relevant to the European Union. Even in North America, the incorporation into NAFTA of side deals on the environment and labor has shown that we are not immune to the risk of a shift of power to the supranational level. In the campaign to overcome the powerful centralist forces at work everywhere, federalists need all the friends that they can find.

## Constitutional Safeguards Less Urgent

In a more optimistic perspective than suggested by Buchanan, I would even submit that in a world where the federalist process is

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forced upon us by outside conditions, namely free trade, the task of setting constitutional safeguards by political action loses some of its urgency. The international federalist competitive model comes into play without it being necessary to limit, legally or constitutionally, the legislative power of the various national governments, provided the mobility of resources is not hampered. In a decentralized system, such as occurs after free trade, exit, not voice, is the paramount instrument at the disposal of individuals to discipline their government and make their preferences known.

## Centralization, Community Bonding, and National Survival

Finally, in support of Buchanan's opinion that "community bonding" is an active value in society that can preferentially flourish in a federal system, I would like again to offer the example of recent events in Canada. In Canada, the shift of transfer activities to the central government from local communities was not only instrumental in weakening the welfare state, but it has jeopardized the very survival of the Canadian federation. In contrast with what conventional wisdom would have us believe, the unity of a federation does not require a strong central government. Quite the opposite. Centralization is everywhere the enemy of harmony inside national communities, whether they be linguistic, ethnic, religious, or simply historical. Current threats to national unity in Canada are evidence that antagonisms rather than peace and social cohesion are likely to result from attempts by central authorities to engage in vast redistributive operations between regions and communities.

Such a situation is not limited to Canada. The collapse of centralist regimes in Eastern Europe and in the former Soviet Union should serve as a reminder that wealth redistribution by a central authority does not bring national or ethnic communities closer together. It is doubtful that the political integration of East and West Germany has yielded more advantages than would have been created by two distinct market-oriented economies with free movement of goods and factors (see Becker 1990). Subsidizing the continuation of inefficient uses of labor and capital in the eastern part is causing more conflicts than promoting national reconciliation. Whether in the former Soviet Union, Turkey, Canada, the former Yugoslavia, or in Europe as a whole, decentralization seems to be a major instrument to tame ethnic feuds. When minorities have more local autonomy within loose federations and more freedom of trade and movement across borders, they are less likely to feel oppressed and harbor hostilities. In effect, they


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are more likely to assimilate freely into the larger wholes in the long run. Moreover, under free-trade regimes, large-scale migrations are made less necessary and less likely by movements of capital and goods.

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# BOOK REVIEWS

**Perfect Competition and the Transformation of Economics**
Frank M. Machovec
London: Routledge, 1995, 391 pp.

Rarely does a book have the power to improve economists' fundamental vision of their subject. Frank Machovec's *Perfect Competition and the Transformation of Economics* is such a book. We've all seen dramatic testimonials on the covers of popular novels: "It grips the reader from the first page. . . can't put it down. . . a real page-turner." Most economists will feel the same about Machovec's work. It is genuinely exciting, one of the most important works in economics published in the past 10 years.

Machovec's thesis is that the profession's embracing of perfect competition constituted a Kuhnian revolution in which, tragically, the superior conception of competition as rivalry was overthrown. He establishes, first, that rivalrous competition dominated economics from the classical period to the early 20th century but that perfect competition dominates it now. This demonstrates that those who perceive a smooth continuum, incorrectly identifying classical competition as a crude attempt at perfection, misread doctrinal history and that a revolution did in fact occur. He then argues that, in several respects important to both theory and policy, the consequences of this revolution have been disastrous and that a return to rivalry and the method it requires would much improve our subject.

Readers acquainted with some controversies in the history of macroeconomic doctrine may notice a parallel. Although Kuhn wrote about the physical sciences, economists quickly applied his thesis to Keynesian macroeconomics. But what did this revolution overthrow? W. H. Hutt (1979) in *The Keynesian Episode*, Leland B. Yeager (1973) in "The Keynesian Diversion," and a number of other writers, including Henry Hazlitt, Ludwig von Mises, and Arthur Marget, have argued that pre-Keynesian theory was superior to that which replaced it. They perceived the reemergence, from the Keynesian morass, of pre-Keynesian truths, and predicted that the profession would eventually look back on "the Keynesian episode" with shame and embarrassment.

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Neither these writers in monetary theory, nor Machovec in the theory of markets, yearn for a return to Adam Smith. Many advances had improved each field by the early 1900s, but both the macro and the micro states of the art (value theory excepted) were within the spirit of the classical conceptions. In this century's early decades, however, received doctrine was overthrown—consciously by Keynes and his young followers, unwittingly by those who misidentified rivalrous competition as a crude and bumbling effort to describe perfect competition. To the extent that they share a methodological cause, it is not coincidence that these revolutions occurred almost at the same time. In any case, each diverted generations of brilliant and hard-working economists into theoretical structures that hindered genuine advance, and one can share Hutt's (and Machovec's) convictions that, had these scholars not been hobbled by misleading paradigms, we would have avoided costly errors of policy and theory and be richer and smarter than we are.

Hutt and Machovec share the attributes of scholarship warmly received by the modern Austrian School, yet neither identifies himself as "an Austrian economist," each viewing his work as continuing and perhaps reestablishing the classical tradition. As Machovec puts it, "Austrian economists see the market process much as the classical economists saw it" (p. 22). If they are right, Frederick Nymeyer (1960), the American publisher of Bohm-Bawerk, was correct to advertise the Austrian School as "neoclassical," and what we know today as "neoclassical" should more accurately be considered neo-Ricardian, neo-Cournotian, or neo-Walrasian.

The book's exciting "real page-turner" character is partly attributable to Machovec's courage. He doesn't just argue that the prevailing history of the theory of competition is wrong; he forcefully maintains that the older paradigm, overthrown and largely discarded, is superior. This review will consider his history of the theory of markets, then turn to his positive case for a reestablishment of rivalry.

Machovec illustrates that a popular and perhaps dominant belief interprets perfect competition as the result of many decades of evolutionary refinement of the classical concept of competition, an understandably primitive version of it. As evidence for this reading of the classical concept, one thinks of classical writers' concern with long-run zero-profit equilibria (like Smith's "natural price"), their opposition to "monopoly," the implicit assumption of perfect knowledge in their "law of one price," their general belief in laissez-faire, and their muted role for the entrepreneur. The modern neoclassical economist, typically undertrained in the history of his subject and susceptible to evolutionary theories of the growth of knowledge, is likely to accept this evidence casually and generously as confirmation of something he wants to believe.

These interpretations, Machovec explains, are unwarranted. Some result from the mistaken application of modern meanings to a period in which the same words were used differently. The simplest example is that Smith's disapproval of "monopoly" was of illegitimate government



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privileges, not of downward-sloping demand curves (p. 16). As for laissez-faire, the modern theorist might be able to justify it on welfare grounds only under perfect competition, inferring that classical advocates unknowingly presupposed perfect competition. But laissez-faire is also consistent with, and more easily and strongly supported from, a rivalrous perspective.

Machovec defends classical economists' concern with long-run equilibria, but emphasizes their explanations of the active interplay by which equilibria are approached. He reminds his readers that every prominent Austrian economist—even Ludwig Lachmann—has acknowledged the importance of the analysis of equilibrium (p. 21).

Chapters 4 and 5 are devoted to proving that entrepreneurship and uncertainty were central to the British classical conception of competition, even if the entrepreneur was "more prominent and better developed in the Continental texts" (p. 136). Machovec's evidence for those attributes of competition and the institutions associated with them seem somewhat strained at times. In his discussion of Mill's social philosophy, for example, Machovec does not make it immediately clear that his discussion is intended to illustrate Mill's understanding of incentives and the superiority of general rules over designed outcomes in coping with uncertainty.

The rivalrous paradigm constituted Kuhnian "normal science" until the 1920s. There is no doubt that it was overthrown; but if Machovec is to associate that overthrow with *The Structure of Scientific Revolutions* (Kuhn 1970), he should identify the real or imagined errors—or the important outcomes incapable of explanation—in the prevailing paradigm. He does not do so, perhaps because (in this reviewer's judgment) the revolution was more a matter of methodological taste than of any substantive dissatisfaction with rivalry.

Although Keynesians thought (wrongly) they were dismissing a flawed theory filled with holes and errors, the motivation for perfect competition was the mathematical method. Encouraged by the discovery of some overlap between the conclusions of old-fashioned rivalry and the solutions to equations, economists embraced the modern age and, without much regret, brushed aside those aspects of the preceding paradigm that could not readily fit the new method. I don't know if Machovec would buy this interpretation; he identifies himself as "an unequivocal supporter of the value of formalism in economics" who agrees with William Stanley Jevons that "the widespread employment of calculus is inescapable" (p. 9). But a physical-science background like Machovec's does not inevitably lead to these conclusions, and while he commendably offers frequent cites of F. A. Hayek's essays on knowledge and competition, some attention to *The Counter-Revolution of Science* (Hayek 1980) and other discussions of scientism would have been helpful. (This book also never mentions Murray Rothbard, whose writings on method [e.g., "The Mantle of Science" (Rothbard 1960)] are undeservedly slighted by many young Austrians but accurately express what the method of Menger, Bohm-Bawerk, and Mises implies for mathematics in economic analysis.)



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A Kuhnian story is more powerful if one can identify a unique revolutionary spark. For Machovec it was one book: Frank Knight's *Risk, Uncertainty and Profit* ([1921] 1971). He sees Knight as "the leading expositor of the perfectly competitive model" (p. 265). But Knight's role as "leading expositor" has been controversial, most recently on the Austrian economics Internet discussion group, and I shall not try to resolve it here. Knight, the classic "puzzler" (Hayek 1978), is often delightful (Knight 1956) but was on the wrong end of the capital controversy with Hayek.

Despite Machovec's criticism of Knight's refinement and formalization of the concept of perfect competition and his criticism of George Stigler's (1957) history of perfect competition, it seems as if Machovec goes too easy on the Chicago School. Neither Melvin Reder's (1982) "Chicago Economics" nor Milton Friedman's (1953) "Positive Economics" is mentioned. And although Machovec's praise is often deserved (e.g., of Stigler's contributions to industrial organization and the Chicago School's promotion of "the free market"), he should have addressed the Friedman/Stigler thesis that the model of perfect competition may be unrealistic, but that's not relevant—what matters is that the model provides the best prediction per complexity. Machovec should not let the Chicago School off so easily.

So why should anyone care, or regret, that perfect replaced rivalrous as the dominant concept of competition? This is Machovec at his most exciting, explaining not only that economics took a turn but that it took a *wrong* turn, and why.

Horizontal demand curves are not, in themselves, the main culprit. When Machovec writes of "the concept of perfect competition *and the analytical habits of thought attendant to it*" (p. 1), he is referring to several ideas sharing the theme of knowledge. If, for example, each seller is a "taker" of the market equilibrium price and perceives himself incapable of affecting it, how does price ever reach equilibrium? The Walrasian auctioneer leaps conveniently to mind, the *deus ex machina* who analytically replaces the entrepreneur but obliterates any chance of understanding how markets really equilibrate. One is left depicting the entrepreneur as an exogenous force throwing equilibrium into disequilibrium, as (or more) likely to cause harm as good. In one way or another, it is this misunderstanding, this inability to appreciate the function of the entrepreneur, that forms the common theme of Machovec's argument that replacing rivalrous with perfect competition was a terrible mistake.

He introduces the theme early, with his wide-ranging "The Magnetic Lure of Market Socialism" (Chapter 3). Why did—and, to some extent, still does—this fatally flawed construct attract economists like iron filings to a magnet? Machovec's convincing answer is that they were "disarmed" (p. 4) by the perfect-competition model's dismissal of the entrepreneur and his knowledge-creating function. Lacking the rivalrous-process competition of the classical economists and Austrians that provides the analytical structure for understanding and appreciating entrepreneurship, they also undervalued the institutions required for its implementation. These include the recognition that since entrepreneurship is costless yet can



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create immense value, gargantuan rewards stemming from little or no *effort* are not necessarily undeserved (p. 84). Citing writers as diverse as Dostoyevsky and Mises, Machovec concludes that "entrepreneurship and the process of a *private*-enterprise market are inseparable phenomena" (p. 94).

Machovec illustrates how these unfortunate misapprehensions have affected industrial organization and antitrust, economic development and comparative systems, and international trade. Observations on industrial organization are scattered throughout. He cites Nassau Senior's observation, for example, that "a large number of producers is not necessary to guarantee that price equals cost. An absence of entry barriers is sufficient to ensure this result" (p. 118). Sections of Chapter 6 ("The Perfectly Competitive Model: Evolution or Revolution") address product differentiation and advertising. Chapter 7 ("Competition and the Law") examines the "old" and "new learning" in antitrust, identifying the former structuralist view with the perfect-competition habit of thought and the latter with the reemergence of the rivalrous-process view. While the analysis and exposition are very good, some readers may regret Machovec's apparent approval of antitrust to thwart collusion (p. 219) and his book's omission of any reference to D.T. Armentano's (1990) classic *Antitrust and Monopoly*.

In Chapter 11 ("Stylized Assessment of Gain Versus Pain") Machovec summarizes his evaluation of the effects of the model on the four fields mentioned above. While one can never calculate the dynamic losses that antitrust policy shaped by "the Walrasian mode of thinking" imposed (imposes) upon the United States, "the costs of neoclassical thinking have been paid disproportionately by those who live in the Second and Third Worlds" (p. 295). With First-World economists promoting growth and development through deliberate planning, denigrating entrepreneurship, markets, and the institutions required for them, can one reasonably doubt Machovec's contention? His concluding Chapter 12 offers a convenient recap of his arguments and an optimistic belief for a non-Kuhnian (that is, non-overthrowing) synthesis of "new institutionalists, transaction-cost theorists, and Austrians (the I-T-A group for short)" with neoclassical theorizing.

A book this important deserves the best editing and production. One hopes that a subsequent edition will correct the many errata (the author's list of about 50 is welcome) and reorganize to eliminate choppiness. Has computerization actually reduced production values compared to academic books from commercial publishers of 50 years ago?

A book this important also deserves the widest reading. Routledge and its "Foundations of the Market Economy" series editors Mario Rizzo and Lawrence H. White warrant our congratulations for offering it to us, but it is Frank Machovec who is to be thanked for this superb contribution to our science. Everyone who reads it is sure to come out a better economist.

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**Regulatory Takings: Law, Economics, and Politics**
William A. Fischel
Cambridge, Mass.: Harvard University Press, 1995, 415 pp.

In 1922 Justice Oliver Wendell Holmes declared in *Pennsylvania Coal v. Mahon* that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking." Holmes did not explain how far is "too far," and subsequent efforts to provide an operative definition for the Fifth Amendment's "takings clause" have proved notably unsuccessful. Yet as environmental and other restrictions on land use and exactions on development have become more prevalent, the need for a secure and predictable definition of constitutionally protected property rights has grown more acute.



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In the preface to his fresh and insightful new book, William Fischel promises "an eclectic selection of economics, legal scholarship, history, political science, quantitative evidence, and personal experience." That's what the reader gets. The sure-footed way in which he weaves together strands of economics, law, history, and just plain politics brings to mind the work of Robert C. Ellickson, whose contributions Fischel acknowledges.

In addition to teaching economics at Dartmouth, Fischel is a member of the Hanover, N.H., zoning board—clearly an experience that has given him empathy for the regulators as well as the regulated. His omnivorous curiosity and engaging style enabled him to utilize a visit in California and field trips to places like Scranton, Pa., to get the behind-the-scenes story from developers, lawyers, engineers, and others in the know, as well as to review primary source materials.

Fischel's journey to Scranton revealed that Justice Holmes's decision in *Pennsylvania Coal* had almost no practical effect. Given that townspeople, miners, and executives alike lived over the anthracite seams in a narrow valley, it was customary both before and after the Court's ruling for the companies to repair subsidence damage to homes. While the companies' victory spared them frivolous lawsuits for minor subsidence, the continuing social and economic relations among the parties dictated that they act as good neighbors. Fischel attributes our conceit that the case had to have made a big practical difference to the "legal centralism" of lawyers and judges.

Yet legal rules often do determine outcomes. Fischel's interviews demonstrated that developers and local officials well understood the intent of the California Supreme Court to thwart development at every turn. Systematically evaluating possible contributing factors, Fischel concludes that judicial policy was primarily responsible for the explosion in California home prices, which went from 35 percent above the national average in 1970 to a disparity of 147 percent by 1990.

The major themes of Fischel's book are that we should rely on competitive forces rather than courts for the protection of property rights from uncompensated takings, that statewide regulation is more apt to protect the value of immobile property than local regulation, and that the "normal behavior" standard advanced by Ellickson is the proper touchstone against which to measure owners' property rights and government exactions.

However, one reason why Fischel is so successful in harmonizing property rights and economic efficiency is his implicit view that there is no fixed, or pre-political, meaning of "property" to which the framers adhered, or that the Fifth Amendment served to confirm. Indeed, Fischel explicitly adopts John Hart Ely's "process theory," under which judges should not reverse the decisions of legislators except where the legislators themselves have acted undemocratically. Yet Ely's support for the notion of preferred freedoms and fundamental rights is in line with the Supreme Court's famous footnote four of *United States v. Carolene Products Co.* (1938), which established the bifurcated system under which so-called



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personal rights became more worthy of judicial protection than property rights.

Likewise, Fischel's repeated illustrations of how legislative support for property rights varies with their perceived economic value vis-à-vis redistributive regulations bespeak a utilitarian orientation that does not address other roles that property rights play in our society, such as enhancement of individual liberty. Fischel suggests that viewing the takings clause as providing more substantive rights, as suggested by Richard Epstein and others, would lead either to an amount of judicial intervention unseemly in a democracy, or to a continuation of the current intellectually untenable distinction under which physical takings are compensated and regulatory takings generally are not. He might be correct on the latter point, but that only points out the lack of a solution to the regulatory takings problem, not the lack of need for one.

The one situation where Fischel does concede the need for judicial support for property rights is where owners have immobilized assets that are at the mercy of a political process in which they have no meaningful participation. His proffered examples are suburbs in which homeowners vote to obtain monopoly returns by precluding development of the remaining vacant parcels, and municipalities in which tenants vote in rent control so strict as to preclude owner withdrawal of capital. Where regulation is imposed at the state or federal level, however, Fischel is more sanguine that property owners have a chance to mobilize effectively.

The problem of potentially exorbitant exactions on development can be solved, in Fischel's view, through application of the golden rule. If imposition of development fees has been the policy all along, new developers shouldn't object. If it has not been the locality's "normal behavior," or if the developer's building plan is similar to what had been "normal," but which is now forbidden, relief is in order. Fischel tells us, though, that the public view on what is "normal" land use may change, sometimes fairly quickly. But reconciling democratic change with the need for stable and objectively legitimate notions of "property" is the crucial issue.

If the foregoing suggests that Fischel has not solved the regulatory takings problem, that does not detract from his genuine accomplishment. He explicates difficult legal issues for nonlawyers, and he uses economic analysis in varied and powerful ways to help clarify both theoretical and practical aspects of the takings problem. Particularly instructive are his analyses of how the Tiebout model of intersuburban competition can serve the public welfare, and how damages instead of injunctive remedy could curb municipal overreaching. Fischel's work will enrich the understanding of lawyers, economists, and policymakers. We need all the help we can get.

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**Policy, Exchange Rates, and the International System**
W. Max Corden
Chicago: University of Chicago Press, 1994, 332 pp.

W. Max Corden has produced a well-crafted analytical text that is an extensive revision of *Inflation, Exchange Rates, and the World Economy*. Aside from chapters 2, 3, and 11 the material is essentially new. The subject matter is divided into four general areas, each comprising one or several chapters. The introduction presents the reader with a set of properties that characterize the present international monetary system (i.e., what are the key issues, and what specific problems do they create for the system?). Chapters 2 through 6 essentially analyze the adjustment process in open macroeconomies. These chapters form the analytical core from which three general issues in international monetary economics are discussed: (1) the prospects for monetary cooperation in Europe [chaps. 7–9], (2) the quest for stability in the greater international monetary system [chaps. 10–13], and (3) the relationship between exchange rates and protectionism [chaps. 14–15]. The book concludes with a chapter in which Corden critically assesses various proposals for an international monetary regime, and ultimately goes on to give his own prognostication for the future.

The presentation of the subject matter within each general area appears as a kind of potpourri of the latest thinking on central issues regarding adjustment and its applications to policy: Corden's own analysis bears upon the conventional wisdom of adjustment, debunking some ideas while affirming others. The result is a collection of stimulating and important conclusions regarding how nations can and do adjust to both internal and external economic disturbances so as to achieve specific policy goals in both their macroeconomies and the greater international economy.

The book's title is quite appropriate in that the logical progression of Corden's arguments runs from the central role of exchange rates in the adjustment process to the opportunities and dangers that role presents for the international monetary and trading system and a smaller subsystem (Europe), and, finally, based on these opportunities and dangers, Corden considers the most useful policies national leaders can pursue in reforming international monetary relations. But even beyond this logic, there seems to be a pervasive theme that is not so boldly stated by Corden (most of whose arguments about the preferability of one exchange rate regime over another are hedged)—namely, the usefulness of flexible exchange rates. Although falling short of formally proclaiming himself a floater in this book, it is clear that his conclusions suggest that flexible exchange rates are better adapted to today's international political economy.

Europe does not appear to be an optimal currency area. Thus, adjustment costs under fixed rates or monetary union would likely be greater than they would under flexible rates. Although erratic exchange rates may reduce trade, fixed rates also work against liberalization because the loss of the exchange rate instrument tempts policymakers to substitute



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protection. Flexible rates can encourage liberalization since they can be used to provide short-term relief for the loss of sectoral or national competitiveness. Moreover, fixed rates would be difficult to institute in the greater international monetary system; the world as a whole is quite far from being an optimal currency area. Corden's own forecast is that the managed float is here to stay: the "nonsystem" will prevail.

Fundamental to Corden's leanings is a keen political savvy, which pervades the book: in today's world, limiting the use of exchange rates as a policy instrument imposes heavy political costs. Since macroeconomic policies are essentially targeted toward internal goals (employment and inflation performance win more elections than current accounts), policymakers will only grudgingly give up compensatory instruments.

Where does all this leave us for the future? Do we have to continue to live with erratic movements in currencies? Not if nations pursue Corden's lowest-common-denominator strategy: nations should strive to pursue stable and predictable macroeconomic policies, while using sterilized intervention cum monetary policies (i.e., limited intervention) to smooth out the short-term currency bumps. This solution to the problem of monetary cooperation not only reflects Corden's political savvy, it also reflects what is another pervasive theme of the book: that large-scale intervention in markets (i.e., strong multilateral management) is not necessary to reach desirable outcomes in the international monetary system.

This persuasion not only suggests that the present nonsystem of managed floating is not so purgatorial, but also that present outcomes in the international economy are not as destabilizing or conflictual as they appear. In this sense, we come to see the so-called major problems of the international economy (which Corden discusses in his introduction) in a different light. There is concern over the large Japanese current account surplus, yet the high rate of saving—which to a great extent drives the surplus—provides a supply of capital that keeps world interest rates lower than they would otherwise be. Americans see their trade imbalance with Japan as a problem, yet deficits are to a large extent the result of good things (e.g., high domestic investment). Moreover, international lending from Japan to the United States allows both countries to assume their preferred positions on the consumption-savings continuum (a Pareto-superior outcome to one where consumption and saving patterns deviated).

What about the gyrations of the dollar during the 1980s? Although the swings were big, most of the movements (outside of the speculative bubble of 1984–85) were in an equilibrating direction. Having maintained the dollar well outside of its purchasing power parity range would have been far worse. Is the high level of capital mobility in the international financial system destabilizing? Movements of exchange rates will often be in an equilibrating direction, and this is a good thing. In the long run, speculation is a better way of facilitating changes in exchange rates than intervention by policymakers. The former promises to be on average smoother and closer to true market values. Should nations be concerned



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that they are lagging behind other nations in real growth (e.g., are American industries and the economy threatened by faster Japanese growth)? Void of production biases, growth transmits positive outcomes to other nations in terms of both income and terms-of-trade effects. In sum, a careful scrutiny of the complex consequences of all these outcomes suggests that things are not as bad as common wisdom portrays.

Corden's book is far more than a textbook; his arguments take us well beyond the basics of the conventional theoretical building blocks of international economics. Corden's complex analysis of adjustment and its role in the central issues of international monetary relations ends up turning into his own unique treatise on the subject, a treatise that is constructed out of an agglomeration and synthesis of Corden's own past thinking on differing issues relating to adjustment. In this respect, Corden achieves an enviable goal: a book that is good for both the relative beginner (undergraduates with some grounding in international economics) and the experienced scholar. As the product of one of the godfathers of international economics, this book represents an offer you can't refuse.

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**No Turning Back: Dismantling the Fantasies of Environmental Thinking**
Wallace Kaufman
New York: Basic Books, 1994, 212 pp.

Until a very few years ago the environmental movement was almost totally exempt from academic criticism. By mid-century many aspects of the American environment were truly in need of improvement, and environmentalists convinced the American people that theirs was a just cause opposed by rapacious business interests. Indeed, environmentalism became entwined with the collectivist desire for social control, which was popular with large segments of the media and academia. What Walter Williams has called "watermelon environmentalists" (green on the outside and red on the inside) are still very much a part of the more radical fringes of this movement. With the advent of government agencies and private organizations whose professed intent was to protect the less enlightened from environmental catastrophe, large numbers of people became "professional" environmentalists. As with any group of this kind, their first duty was the suppression of opposition. And what a job they did! Those who questioned their findings became "purveyors of junk science" or "dupes of industry," or worse. The media became very nearly closed to critics, and environmentalism became a kind of religion, whose mysteries were known only to the select cognoscenti.

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Critics of environmentalism are still far from legion but they have at least become a presence. Wallace Kaufman's position among these critics is that of a "turned" environmentalist. Once an active environmentalist and environmental lobbyist, Kaufman now offers a "kiss and tell" exposé of the movement. His book offers enough new information to be of interest to seasoned critics, but it should be of greatest benefit to those who want a good overview of the environmentalist mind set.

Kaufman begins by covering familiar ground. He notes that although we may care a great deal about nature, nature does not give a fig about us. It is only by exerting control over nature that the several billion people currently living on this earth can possibly survive. He reviews a number of dire predictions about the environment, showing them to be overblown, without scientific foundation, and precursors of policy prescriptions with outrageously high cost/benefit ratios. Kaufman points out that previous false predictions of doom, such as those on population made by butterfly specialist Paul Ehrlich or by the Club of Rome, were forgotten without a scintilla of accountability for their prognosticators. The attitude of earlier conservationists, who believed in improving nature through scientific management, has been replaced by a hysterical antiscience rhetoric.

Kaufman then traces the environmental movement through Rousseau, Malthus, Wordsworth, and other romantic poets and pessimists. He portrays Henry David Thoreau as a major influence on 20th-century environmentalism in the United States and does a credible job of linking romanticism and socialism. Like many economists, he is astounded by a movement that seeks to reduce the quantity of goods and services provided to the peoples of the world. Such a movement, he correctly points out, must resort to redistribution to assuage those at the bottom of the economic ladder.

One of the more interesting sections of the book has to do with the environmental movement's penchant for deifying the earth and declaring certain primitive peoples (most notably, in the United States, the American Indian) to be keepers of the kingdom. Consider the famous "speech" attributed to Chief Seattle, which is usually spoken by an American Indian actor with a tear in his eye. It begins, "How can you buy or sell the sky? The land? The idea is strange to us. Every part of this earth is sacred to my people." These lines, and those that follow, are quoted by public television programs ( not to mention Al Gore) so often that our children practically have them memorized. Yet they were never uttered by Chief Seattle. They were invented in 1971 by Professor Ted Perry for the ABC film "Home." In an attempt to put to rest the romantic notion of the noble savage, Kaufman cites the brutality of many primitive peoples as well as their general disregard for nature. Only people who have little to do with nature consider it benign.

Kaufman next reviews some of the misleading statistics and science that underpin many claims of the environmental movement. This material has been covered elsewhere to better effect (e.g., Ronald Bailey's *The True State of the Planet*), but Kaufman's overview is still useful.


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There is also a brief review of the now massive "takings" literature. Kaufman feels that the takings issue has perhaps been most responsible for generating grassroots opposition to the environmental movement. Private property rights are deeply embedded in the American psyche, Kaufman believes, and clashes between environmentalists and private property owners are sure to increase.

One of the more interesting themes of the book is the discussion of the changing attitude among some scientists concerning natural states of equilibria. Kaufman sees nature more as a chaotic-dynamic process, making it silly to speak of a "balance of nature." Large populations of animals come and go with astonishing frequency. The face of the earth itself writhes and heaves unpredictably. All that happens without the interference of mankind.

I doubt that chaotic models will replace more traditional equilibrium models any time soon in science or in economics. However, one does not need to fall back on chaotic-dynamics to reach Kaufman's conclusion that our best course is to continue to adapt nature to our needs through the use of technology rather than passively to accept natural events. For Kaufman, as for Julian Simon and many others who have thought about these issues, the ultimate resource is the resourcefulness of human beings.

Kaufman has written a book that deserves a wide readership among people who desire to deepen their understanding of the environmental movement. Environmentalists, however, will despise its every page.

Ben W. Bolch
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**An Essay on Rights**
Hillel Steiner
Oxford: Blackwell, 1994, 305 pp.

It is a commonplace that the past few decades have witnessed an explosion of rights. "Human rights" seem to have multiplied endlessly. Each individual is asserted to have a right to welfare, a right to self-esteem, a right to health care, even, according to the United Nations' Universal Declaration of Human Rights, a right to "periodic holidays with pay." Unfortunately, these rights often conflict with the older human rights that classical liberals had fought for: the rights to life, liberty, and property (or the "pursuit of happiness"); the right to be secure in one's home and possessions; the right to be left alone to worship God or to find one's happiness as one sees fit. Such classical liberal "negative" rights do not conflict with each other, whereas "positive" rights to be provided with things produce many conflicts. If my "right to health care" conflicts with a doctor's "right to liberty," which one wins out? Will the doctor be forced to provide me with my health care? And to how much health care do I have a right, if the doctor also has the right to "periodic holidays

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with pay?" (And to how many "periodic" holidays does the doctor have a right?)

As entitlements have multiplied and, increasingly, clashed with each other, traditional rights theory has been robbed of its very meaning. The traditional liberal notion of rights was precisely that rights *cannot* clash. The point of rights is to guide each person as to which actions are permissible in order to avoid conflicts among individuals or groups and to allow each person his freedom.

Rights theory took the wrong turn when it made "right" a mere synonym for interest or benefit: whenever something is in my interest (say, receiving free medical care or paid holidays), then I can claim a "right" to it. But as interests can conflict, rights-as-synonyms-for-interests can conflict as well.

The intellectual errors and problems of such misguided rights theory are brilliantly analyzed by University of Manchester philosopher Hillel Steiner in his book *An Essay on Rights*, the result of years of hard thinking about the topic. Steiner has gained a reputation in the field of moral and political philosophy by his insistence on "compossibility" as a criterion of rights. A set of "compossible," or mutually consistent, rights means that the actions they legitimate must be jointly performable. Steiner indicts almost all of contemporary rights theory—the kind that has generated the rights explosion—as fundamentally mistaken: "Any justice principle that delivers a set of rights yielding contradictory judgements about the permissibility of a particular action either is unrealizable or (what comes to the same thing) must be modified to be realizable."

Property rights satisfy the compossibility criterion, because when they are well defined they precisely inform people about what they may do with reference to particular material objects. On the other hand, vague, floating rights such as a "right to privacy" (as distinguished from a right to private property, which is how we normally ensure our privacy) come into conflict with equally vague rights such as the "right to know" or the "right to free expression." Your right to know about me or to speak about me might conflict with my right to privacy, and if that is true, how are we to know what we should do or what we are morally entitled to do? Property rights, on the other hand, allow us to pursue our interest in privacy or our interests in knowing without inherent legal conflicts requiring an all-wise and all-benevolent legislator to sort them out.

For these (and other) reasons Steiner considers rights and property to be coextensive. "A set of categorically compossible domains, constituted by a set of property rights, is one in which each person's rights are demarcated in such a way as to be mutually exclusive of every other person's rights." First and foremost among these rights, and the source of the traditional rights of association, speech, worship, and the like, is the right of "self ownership," the right that John Locke put at the foundation of his theory of property and justice. The rights of self-owners are necessarily compossible, for each person is responsible for one body, his own. (Steiner also discusses the cases of parent/child and guardian/ward


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relationships as special applications of the general principle.) The result of Steiner's work is a brilliant reworking and defense of "classical *laisser faire* liberalism of the natural rights-based kind."

Steiner's arguments are complex and rigorous, taking up technical issues at the very cutting edge of moral and political theory. Steiner manages to make them accessible by means of a very ancient technique pioneered by Plato: the dialogue. Various positions are compared by means of characters who articulate and defend them, revealing the strengths and weaknesses of each. Although not the best dramatic exchanges I have ever read, the dialogues in *An Essay on Rights* serve Steiner's purpose of making often quite complicated arguments clear and easy to grasp.

Even when I could not endorse Steiner's conclusion, his arguments forced me to rethink my reasons carefully. Steiner is a master of logical argument and if you like exercising your mind, you will thoroughly enjoy the experience. There is one issue, however, on which I believe he has made a crucial error, and as it is clearly of great importance to Steiner, I should mention it. In an "Epilogue" on "Just Redistributions," Steiner endorses what used to be known as the "single tax" idea of Henry George. Georgists allege that one cannot legitimately own naturally occurring resources, but can only have rights to the value one adds through one's work. Therefore, those who use such resources must pay a tax (it is rarely indicated to whom) reflecting its value. Setting aside the perhaps insuperable difficulties of actually implementing such a scheme, especially on a global basis, the key philosophical error lies in assuming what the classical writers on property called a "positive community" of unappropriated resources. That was the notion that members of a group have claims to an equal share, as in a partnership from which others can be excluded, as distinct from a "negative community," in which all human beings have an equal right to appropriate unappropriated resources.

The seemingly slight difference between the "right to an equal share" and the "equal right to appropriate a share" has enormous consequences, as Steiner's conclusions show. I found myself quite unconvinced of the arguments offered on behalf of the first formulation. But this in no way detracts from the rigor, the unremitting brilliance, and above all the timely relevance of *An Essay on Rights*. It deserves not only to be on the shelf of every political thinker, alongside John Rawls's *A Theory of Justice* and Robert Nozick's *Anarchy, State and Utopia*, but it also deserves the attention of anyone seeking to repair the damage done by the rights explosion.

Tom G. Palmer
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Herbert R. Northrup, Linda E. Alario, A. J. Thieblot, Gary E. Hess, Michael E. Lucas, Philip A. Miscimarra, and Andrew M. Altschul

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| **Union Wealth: The Bargaining Power Implications** | Marick F. Masters |
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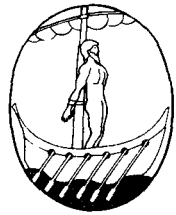

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Friedrich A. von Hayek

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# THE LAWS OF THE MARKETPLACE

Though my heart be left of centre, I have always known that the only economic system that works is a market economy, in which everything belongs to someone—which means that someone is responsible for everything. It is a system in which complete independence and plurality of economic entities exist within a legal framework, and its workings are guided chiefly by the laws of the marketplace. This is the only natural economy, the only kind that makes sense, the only one that can lead to prosperity, because it is the only one that reflects the nature of life itself.

**—Václav Havel**

*Summer Meditations on Politics, Morality and Civility in a Time of Transition*
(London: Faber and Faber, 1992), 62.

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